

***PRIVATISATION IN PREVIOUSLY CENTRALLY
PLANNED ECONOMIES: THE CASE OF AZERBAIJAN,
1991-1994***

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Abstract of Thesis

Privatisation is a central theme in discussions over the transition process of previously centrally planned economies (PCPE). This study examines the developments in privatisation in Azerbaijan, one of the last republics of the FSU to embark upon the road of privatisation. The aim of research was to obtain first hand information on the privatisation process and to construct a qualitative, contextual picture of the power struggle over property rights.

Part one establishes a theoretical framework under which privatisation in PCPEs can be evaluated. It establishes that privatisation can be seen as an instrument to build up a sound system of enterprise control and initiate industrial restructuring, and thus enhance static and dynamic efficiency. The success and effectiveness of this tool is dependent on various factors, especially (1) the evolution of institutional preconditions, i.e. the development of the political, legal, and financial framework and other fundamental institutions of a market environment; (2) the question of the power of the state, i.e. is it a strong state, with agenda-setting power, or a weak state, susceptible to counterproductive rent-seeking activities of insiders; (3) the proposed methods of privatisation; (4) the process of contracting for property rights. By applying the theories of privatisation in PCPEs developed in the first part, the second provides an account of the Azeri privatisation process and its likely effect on static and dynamic efficiency placing special emphasis on institutional preconditions. Because of the nature of the proposed research, especially in grasping the institutional dimensions of Azerbaijan's transition, intensive fieldwork was regarded as part of an appropriate research design. The analysis is based on original Azeri documents and archival records, transcripts of almost 127 hours of interviews, and extensive field visits carried out between December 1993 and February 1995.

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Abbreviations

AAESC	Azeri Antimonopoly and Entrepreneur Support Committee
AIOC	Azerbaijan International Operating Company
AME	Azeri Ministry of Economics
AMF	Azeri Ministry of Finance
ANB	Azeri National Bank
ANS	The Asahi News Service
AP	The Associated Press
ASPC	Azeri State Privatization Committee
ASSC	Azeri State Statistic Committee
AzM	Azeri Manat
AzPF	Azerbaijan Popular Front
CMA	Council of Ministers of Azerbaijan
CPE	Centrally planned economy
DCF	Discounted cash flow
EBRD	European Bank of Reconstruction and Development
FSU	Former Soviet Union
FTB	Financial Times Business Information
MCC	McCarthy Information, Company and Industry Press News and Comment
NESF	National Entrepreneur Support Fund
NKAO	Nagorno-Karabagh Autonomous Oblast
PCPE	Previously centrally planned economy
PE	Price-earnings
SME	Small and medium enterprise
SOE	State-owned enterprise
SWB	BBC Summary of World Broadcasts
TASS	Tass News

Terms of transliteration

The Azeri¹ has been transliterated according to the system developed by Allworth (1971:307) used by most libraries.

Table 1-1: Transliteration of Azeri

Alphabet	Transliteration	Alphabet	Transliteration	Alphabet	Transliteration
A a	a	Й й/J j	y	У у	u
Б б	b	К к	k	Ү ү	ü
В в	v	Қ қ	q	Ф ф	f
Г г	g	Л л	l	Х х	kh
Ғ ғ	gh	М м	m	Һ һ	h
Д д	d	Н н	n	Ц ц	ts
Е е	ye (initially) e (elsewhere)	О о	o	Ч ч	ch
Ә ә	ä	Ө ө	ö	җ җ	j
Ж ж	zh	П п	p	Ш ш	sh
З з	z	Р р	r	Ы ы	i
И и	i	С с	s	Э э	ē
		Т т	t	Ю ю	yu
				Я я	ya

Geographical features

Azerbaijan is situated in the eastern Transcaucasia on the western shore of the Caspian Sea. The republic shares borders with the Russian Federation and Georgia to the north, Turkey and Iran to the south, Armenia to the west and covers an area of 86,600 sq. km, including the Nakhichevan Autonomous Republic (5,500 sq. km) and the Nagorno-Karabakh region (4,400 sq. km). The landscape consists of coastal lowlands and basin of the Kura and Araxes rivers in the east and south-east, and the mountains in the north at the Daghestan border with Mount Basardysy of the Greater Caucasus range rising to 4,466m and in the west near the Georgian and Armenian borders (Lesser Caucasus), with peaks in the far west of the Karabakh rising to 3,581 m. The capital, Baku, is located on the south side of

the Apsheron Peninsula with its natural harbour being the best of the Caspian. The nine different climate zones of Azerbaijan allow a variety of agricultural production including wheat, grapes, tea, cotton, figs and pomegranates, mulberry trees, saffron, and forest products. Important natural minerals include oil, natural gas, zinc, lead, iron and copper ores, bauxite, salt and building materials.

Azerbaijan has a population of 7.4 million (1994), with 53% living in urban areas. There are 65 towns, including 8 with more than 50,000 inhabitants. Half of the urban population lives in Baku (1.7 million), Ganje² (0.3 million) and Sumgait (0.3 million). Azerbaijan is a multi-ethnic society with more than 90 nations and ethnic groups in the country.

Due to the state of undeclared war with Armenia over the Nagorno-Karabakh region since 1988, according to official sources 20,000 Azeris have been killed and 4,400 have been taken prisoner or hostage, with many others being wounded and huge areas devastated. In mid-1994 a cease-fire was negotiated. However, 20% of Azerbaijan remained under Armenian occupation. Almost 1 million people (13% of the population) have become refugees or displaced persons.

¹ The language of the Turks of Azerbaijan is called by Soviet sources "Azerbaijani" and by some Western sources "Azeri". In the following, the term "Azeri" will be used for the language and the population, as it is used in Azerbaijan itself.

² Ganje was called Elizavetpol in tsarist times and Kirovobad from the mid-1930s until January 1990.

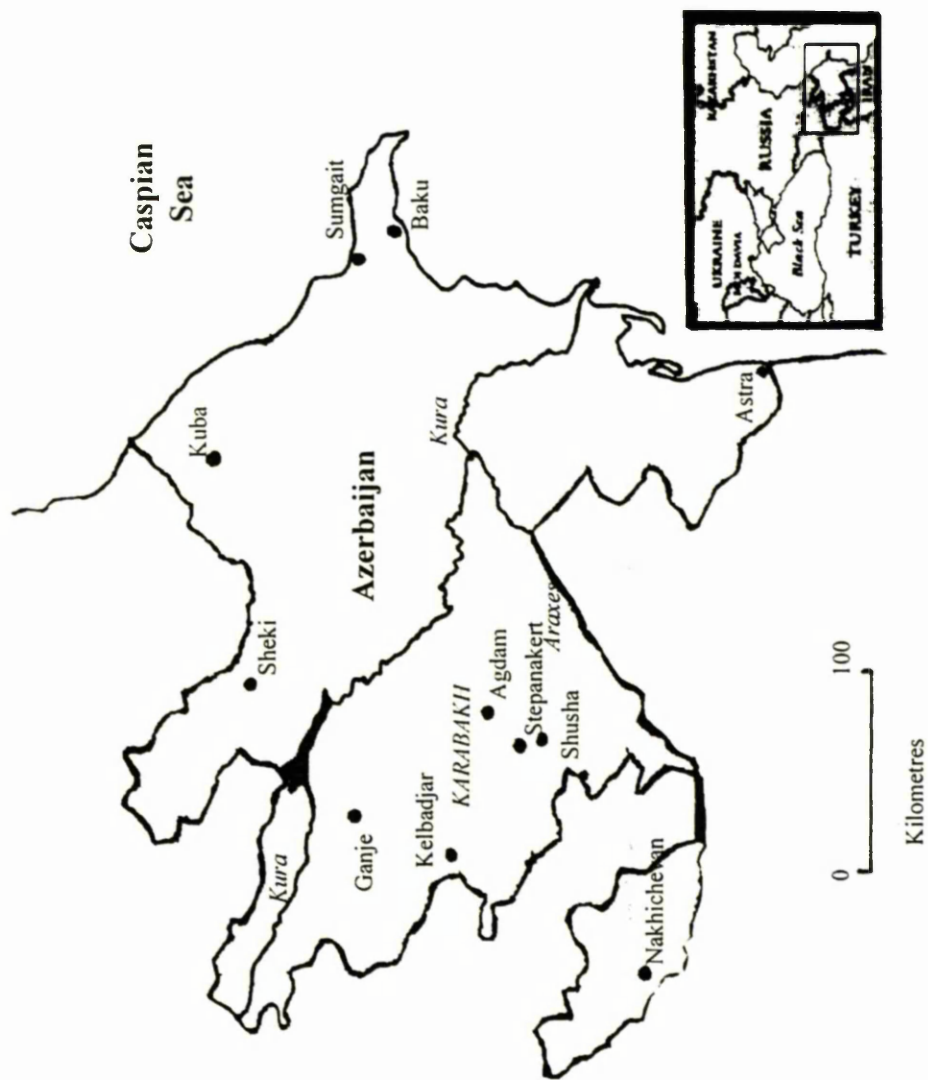


Figure 1-1: The map of Azerbaijan

Table 1-2: Basic information on Azerbaijan

Area	86,600 sq. km
Population	7,430,700 (1994 census), 55% urban. 85,4% Azeris, 4% Russians, 2% Armenians, 9.6% others.
Capital	Baku
Language	Azeri (official)
Life expectancy	71 years (m67/f75) (1993)
Infant mortality	2.8% (1993)
Religion	Islam (mostly Shiite Ithna sect; some Sunni Hanafi school).
Illiteracy rate	4% (1992)
GNP	US\$ 5424 million (1993)
GDP	US\$ 4992 million (1993)
GDP per capita	US\$ 730 (1993)
Imports	US\$ 241 mill. (1993)
Exports	US\$ 351 mill. (1993)
Currency	Manat (US\$ 1 = AzM 4182 on 29 December 1994)
Rate of inflation (retail prices)	1788% (end of 1994)
Foreign debts	US\$ 35.5 (1993)
Minimum wage	AzM 2000 (since 16.6.1994)
Unemployment	27% (Dec. 1992)
Employment structure	Industry: 13% Agriculture: 39% Construction: 7% Transport and communication: 7% Education: culture and art: 14% General administration: 2%
Declaration of independence	30.08.1991
Political system	The parliament is the highest legislature. The President of the Republic is directly elected. The constitution enacted in 1978 is still in place. However, a new constitution has been under discussion since 1992.
President	Heydar Aliiev

INTRODUCTION

Privatisation has been the buzz-word in the discussions over the transition process of previously centrally planned economies (PCPEs).³ It has been declared the ultimate panacea at the micro-economic level for the prevailing economic crisis and was set at the top of the agenda of policy 'advice' directives of IMF, World Bank, and other Western consultants. Built on the belief of the superiority of private ownership, underpinned by rather shallow analytical and empirical support of mainly the Austrian School and the Property Rights School, ambitious and overoptimistic mass privatisation programmes were launched for the privatisation of the entire economy in the shortest time, regardless of sector and enterprise specificities, and overall institutional obstacles of the respective economies.⁴ Eight years into the debate the naïve optimism of most of the crusaders for privatisation has faded. However, privatisation has still remained a priority on the agenda of many PCPEs.

This study examines the developments in privatisation in Azerbaijan, one of the last republics of the FSU to embark upon the road of privatisation. Azerbaijan is better known for its conflict with the neighbouring state Armenia. At the same time, its petroleum resources and strategic location on the Caspian Sea have attracted substantial interest of the international business community, with multinational oil companies at the forefront, and of neighbouring states concerned about the implications of Azerbaijan's successful transition from a Soviet republic to a sovereign state in control of its own resources and foreign policy.

³ The author intentionally refrained from using the standard term 'transitional countries', as it implies a progression from planned to market economy. Considering the uncertainty over the transition process, the author maintains that the transition from a planned economy can follow many paths with no clear destination. Hence the less pre-emptive use of PCPE.

⁴ Institutions are defined as formal arrangements, such as the legal framework, the banking and financing system, the tax system, the labour market, and less intangible attitudes, routines and norms of behaviour which make out the context in which economic behaviour takes place.

The aim of the underlying research was to obtain first hand information on the privatisation process and to construct a qualitative, contextual picture of the power struggle over property rights. The study provides for the first time a comprehensive account of the Azeri privatisation process and its likely effect on static and dynamic efficiency placing special emphasis on institutional preconditions. Because of the nature of the proposed research, especially the aim of grasping the institutional environment, intensive fieldwork was regarded as part of an appropriate research design. Qualitative research techniques are often ridiculed as unreliable, subjective and 'unscientific' (cf. Piore 1983: 76; Downey and Ireland 1983). However, the popularity of qualitative methods and 'methodological marriages' has increased (cf. Silverman 1993: 20-29; Warwick 1993a; Whyte and Alberti 1993).⁵ Considering the volatile environment of PCPEs characterised through rapid change and moreover considering the scarcity of reliable quantitative data, a qualitative approach seems justified for the chosen research object. The analysis is based on original Azeri documents and archival records, which have not been available to academia before, transcripts of almost 127 hours of interviews, and extensive field visits carried out between December 1993 and February 1995.

Contrary to the bulk of literature which equates private ownership with efficiency and hence sees privatisation as the only path leading to the latter, the following analysis establishes privatisation as merely an instrument of industrial policy to build up a sound system of enterprise control and initiate industrial restructuring, and thus enhance static and dynamic efficiency. Various factors are identified on which the success and effectiveness of this tool depends and thus which have to be considered, most eminently, (1) the evolution of institutional preconditions, i.e. the development of the political, legal, and financial framework and other fundamental institutions of a market environment; (2) the question of

⁵ Piore (1983) stresses the benefits of qualitative research techniques for economics. The significance for organisational study is pointed out by Downey and Ireland (1983), Maning (1983), Mintzberg (1983), Pettigrew (1983), Salancik (1983), and Webb and Weick (1983). There is an abundant literature on qualitative research techniques. See, for example Berg (1989), Burgess (1990), Strauss (1987), Strauss and Corbin (1990), Silverman (1993), Patton (1990), and Van Maanen (1983a; 1983b).

the power of the state, i.e. is it a strong state, with agenda-setting power, or a weak state, susceptible to counterproductive rent-seeking activities of insiders; (3) the proposed methods of privatisation; (4) the process of contracting for property rights.

The analysis focuses on 'large privatisation', defined here as establishing private ownership in industrial enterprises. Privatisation in agriculture involves separate issues of agrarian reform and will be therefore not considered here. 'Small privatisation', i.e. the sale of little workshops, catering outlets, shops, etc., involves often only the mere sale of commercial properties and thus is less interesting out of the perspective of enhancing efficiency.

The thesis is organised in two parts. Part one is concerned with the theory of privatisation in PCPEs. The drawn conclusions have not only implications for the debate in Azerbaijan, but also for the debate elsewhere in PCPEs. As most of the literature is based on the assumption of the superiority of private ownership and evolves around technicalities of the privatisation process, the thesis starts off with a critical evaluation of some theoretical underpinnings of this assumption. The analysis reveals the latter as unsustainable. Thus in the reminder of the first part, it is tried to establish an alternative theoretical framework under which privatisation in PCPEs can be evaluated. First determinants of enterprise efficiency in PCPEs are identified. In a further step the very definition of property rights and their formation is scrutinised and privatisation as proposed institutional change is set in the context of the evolving complex process of contracting. Chapter three provides a thorough evaluation of methods of privatisation which have been proposed for PCPEs and which have, to varying degrees, been implemented. It presents a transaction cost framework to assess privatisation methods in PCPEs.

In part two the developed theories are applied in the context of Azerbaijan. The fourth chapter assesses the institutional background in which the privatisation process is set. As major determinants are identified (1) the political and (2) economic conditions, (3) the development of the legal framework of economic activity and (4) the financial infrastructure, and (5) the ability of the state to impose privatisation. Chapter five assesses the legal framework of privatisation,

the role of the State Privatisation Committee (ASPC) and the 1994 draft privatisation programme. The objectives of the chapter are (1) to discuss the strengths and weaknesses of the chosen approach, and possible remedies, (2) to assess the powers of the body responsible for privatisation, and (3) to assess the possible consequences of privatisation on static and dynamic efficiency. Chapter six presents quantitative and empirical evidence on attitudes, perceptions, and expectations around privatisation in Azerbaijan. Incorporating the previous analysis, the final chapter looks at privatisation in the context of the overall contracting process.

The study on privatisation in Azerbaijan covers the period 1991-1994.

PART ONE

1. Why privatise?

Introduction

Privatisation, or "the general process of involving the private sector in the ownership or operation of state-owned enterprises" (Lee and Nellis, 1990: 1), has been a central theme amongst politicians and economists for more than a decade, both in the industrialised countries as well as in the developing world. Motives for privatisation stressed by proponents of privatisation include poor economic performance of public enterprises, the public sector deficit, and the more general over-extension of the role of the state.¹ No doubt, political motives have played a central role in many privatisations.² In developing countries the emphasis of economic reform on privatisation has been partly due to the imperatives of structural adjustment. International financial institutions exercise considerable pressure, and privatisation is one of their conditions for assistance.³ Privatisation, however, has gained a new dimension after the collapse of the Soviet Union and other centrally planned economies in Eastern and Central Europe.

In the context of PCPEs, privatisation is seen as a vital component of the envisaged systemic transition to a market economy.⁴ It is aimed at:

shift[ing] the balance in the ownership structure away from the dominance of the state sector towards predominantly private ownership and control, thus providing the critical mass of private ownership required for the effective functioning of the market economy (Sood, 1991: 102).

However, in scrutinising the theoretical literature on privatisation in previously centrally planned economies, and in examining the evidence of fierce power struggles between various interest groups in the countries concerned, it

¹ See for example, Baumol (1980), MacAvoy et al. (1989), Roll (1982), Vernon and Aharoni (1991) and Vickers and Yarrow (1988).

² For example, see Fine (1990: 113-120; 138-172) for political motives behind the British privatisation programme.

³ For a detailed analysis of the conditionality of international assistance and its implications, see Avramovic (1988).

⁴ See for example, Aghion and Burgess (1992:8), Ash, Hare, and Canning (1994), Hare (1991:5), Hinds (1992:13), Kirchner (1992:4), Kornai (1992:155).

becomes quite apparent that privatisation is promoted primarily out of political motives (cf. Major 1993; Stiglitz 1993: 187).⁵ It is regarded as a political strategy to weaken the power structure of the old elite in the state enterprises and the ministries responsible for these enterprises. As such, it is not aimed simply at transfer of ownership, but at a fundamental change in the underlying attitudes, behaviour and motives of economic agents. The unquestioned belief in the superiority of private ownership is an effective means for these advocates of privatisation who want to induce a rapid systemic change and ensure that the process of overall change is irreversible (cf. Major 1993: 53). At the same time, as the discussion of 'spontaneous privatisation' and 'insider control' have shown, privatisation can be equally seen as a strategy of the *nomenklatura*⁶ to enhance their position.⁷ For those to whom enhancing economic efficiency is the goal, these purely political strategies are hardly helpful.

This chapter examines different theoretical frameworks within which privatisation has been understood. Most proponents of privatisation claim that it enhances economic efficiency, associating efficiency with private ownership. The theoretical underpinnings of the belief in the superiority of private ownership are, however, meagre. General equilibrium analysis, as the principal paradigm of microeconomic theory, is indifferent towards the distribution of ownership between public and private sectors.

⁵ Major (1993: 2) puts it as follows,

[...] all the supportive arguments for privatisation of state owned property that are based on 'pure' economic rationality considerations, such as the gains in economic efficiency by privatisation, or the superiority of private ownership over state ownership as regards flexibility, perpetual innovation and technical progress, rank as secondary in Eastern European political debates.

⁶ The term originates from the party-nominated list of candidates for key appointments in the economic system, termed '*nomenklatura*' (cf. Gregory and Stuart 1994: 186).

⁷ For a more detailed discussion of problems of spontaneous privatisation, see for example, Brabant (1992: 205), Frydman and Rapaczynski (1993 and 1994: 12f.), Johnson and Kroll (1991 and 1995), Maggs (1992), Nagy (1991), Radygin (1995: 27-32), Staniszkis (1991), Szalai (1991), and Voszka (1991 and 1992). See also, section 3.2. For an examination of issues of insider control, see sections 2.1.2 and 3.1.

One important exposition of the belief in the superiority of private ownership is put forward in the socialist calculation debate⁸ by the Austrian School⁹. Although the argument is carried out on the systemic level and is a corollary of the broader debate on planned vs. market economy, it does address the issue of whether private ownership is more efficient than public ownership. The proponents of private ownership and hence privatisation derive their ammunition mainly from the arguments of the Austrian School (cf. Fine 1990: 113-120; Brabant 1992: 14; Rowthorn and Chang 1993: 57; Winiecki 1993: 134-7).

Another theoretical framework within which the superiority of private ownership has been understood is property rights theory.¹⁰ This strand of New Institutional Economics extends neo-classical theory by the penalty/reward structure of property and contractual rights, and the consideration of positive transactions costs.

For an understanding and assessment of privatisation, a knowledge of the underlying theoretical frameworks is extremely important. Thus, this chapter examines the theoretical underpinnings of the belief in the superiority of private ownership. The views of the Austrian school will be outlined and critically assessed in the first section. The second section examines the role of private ownership in property rights theory.

⁸ There is extensive literature on the socialist calculation debate. For a good summary of the debate as well as a bibliography, see Vaughn (1980). For more recent reinterpretations of the debate, see Lavoie (1985), Murrell (1983) and Richter (1992).

⁹ For an exposition of the views of the Austrian school see Dolan (1976), Littlechild (1978), Moss (1976), O'Driscoll (1977), Shand (1980), Spadaro (1978), and White (1977).

¹⁰ For an orthodox survey of the theory of property rights, see Furubotn and Pejovich (1972), and Furubotn and Richter (1991: 1-32). For treatment within an institutional tradition, see DeAlessi (1980; 1983), Eggertsson (1990) and Williamson (1985; 1990). For a more right-wing approach, see Buchanan (1986). Pejovich (1990) and Winiecki (1993: 133-165) have applied property rights theory to economies in transition. Whilst Pejovich focuses on the comparative system level, Winiecki's analysis is pitched at the enterprise level. Both approaches are intended as a rationale for privatisation. However, Winiecki's comparative analysis of various forms of enterprise ownership is set within the market system, so that his line of reasoning for previously centrally planned economies is seriously flawed. His argument that private ownership increases x-efficiency is heavily based on the discipline imposed by the capital market and the market for managers. Similarly the contribution of Pejovich's comparative systems analysis as a rationale for privatisation in economies in transition is debatable.

1.1 The 'Calculation Debate' all over again

In the socialist calculation debate Mises raised the argument of whether an efficient allocation would be possible in an economic system without private ownership of the means of production (Mises 1920: 104). Mises claimed that money prices determined in a market context were necessary for rational economic calculation (1920: 89-104). He argues that, without trade of capital goods, factor prices for capital could not be determined, and without these the contribution of each productive factor could not be evaluated. Thus resources would not flow freely to their most highly valued use (*ibid.*). Mises concluded that without private ownership of means of production, prices could not be adequately determined, and without the price system, resources could not be allocated efficiently.

Socialist economists¹¹ took Mises' challenge seriously, especially Oskar Lange in his famous article "On the Economic Theory of Socialism". Lange (1938) constructed a Walrasian general equilibrium model within which the central planning board substitutes for (or is) the Walrasian auctioneer. In his model the planning board sets prices for goods and factors of production (Lange 1938: 85-86). The factory managers follow the rule of profit maximisation by minimising average costs and by producing an output level at which marginal costs are equated to "shadow" prices (Lange 1938: 82-84). The central planning board adjusts prices in response to any supply and demand surpluses or shortages that might result (Lange 1938: 91-94). Thus the whole process simulates, by trial-and-error, the Walrasian tâtonnement process. In equilibrium, the Pareto-efficient criterion could be met by a socialist as well as a capitalist economy. Lange's conclusion established that standard theory of perfect competition has in itself nothing to do with the private or public ownership of the means of production.¹²

Mises and Hayek rejected the Walrasian model mainly on three grounds (a) the information, and (b) the incentive problems in the model and (c) the dynamic adaptability to changing economic circumstances i. e. that flexibility, perpetual

¹¹ The socialist side of the debate was put forth most eminently by Dickinson (1939), Lerner (1937 and 1944), and Taylor (1938).

¹² Lange's model was also formalised by Arrow and Hurwicz (1960: 34-104).

innovation and technical progress, were not considered in Lange's model. Hence the Austrian criticism of Lange's model was essentially the same as that levelled at neo-classical models, namely it could not capture enough important features of the real world to make it applicable.

The problem with the state "imitating the market", they argued, was that the ex ante prices established by the central planning organisation could never convey accurate information regarding the true opportunity costs associated with resource use (Lavoie 1985: 147). An enormous amount of detailed, specific information would be required to determine "equilibrium prices", i.e. at a macro-level, information about supply and demand of all goods; and at a micro-level, resource supply and technology, in order to determine the least cost combination and the optimal level of output. Even if this information could be made available, it would only be forthcoming at huge transaction costs.

Whilst Lange's model operates under the assumption of perfect availability and communication of price information and general absence of transaction costs, Hayek stresses in his argument around dispersed knowledge that the information required is not given, but is subject to continuous discovery. Moreover the necessary knowledge is divided between various economic agents (Hayek 1940: 140)¹³. Hayek regards it as a question of the discovery and communication of knowledge at a disaggregated level. The latter in its totality would not be available to the central planning organisation. Because of its idiosyncratic attributes, knowledge could not be used efficiently by a central planning organisation in the absence of the competitive process of a market system. For it would be through this process of entrepreneurial action and counter-action and resulting market prices that the dispersed knowledge would be discovered and utilised effectively.

Market prices in Hayek's framework are not parameters. They are the unique and timely results of numerous transactions by individuals guided by their individual access to, and forms of, knowledge. Thus, in turn, the price system serves in Hayek's framework as a means to collect and co-ordinate the dispersed knowledge into a systematic whole (Lavoie 1985: 123-124). Hayek regards the

¹³ For a good presentation of the Hayekian knowledge problem, see Lavoie (1985).

decentralised co-ordination through the price system as an evolutionary 'miracle' and as superior to central planning.

However, in order to get the market mechanism working, which according to Hayek generates the economically necessary knowledge, individual incentives would have to be structured. This again could only happen if property were privately owned.

Both Mises and Hayek regard the functioning of the price formation process as inseparably linked to the rivalry of private entrepreneurs:

[..] it is not possible to divorce the market and its functions in regard to the formulation of prices from the working of a society which is based on private property in the means of production. (Mises 1936: 137)

They stress the crucial role of incentives:

The motive force of the whole process which gives rise to market prices for the factors of production is the ceaseless search on the part of capitalists and entrepreneurs to maximise their profits [...] Without these private owners the market loses the mainspring that sets it in motion and keeps it in operation. (Mises 1936: 137-138)

The lack of incentives would prevent 'as-if' owners representing departments within the central planning organisation from behaving in the same way as real owners (Mises 1936: 518-520). Thus, whilst the 'daily business routine' could be efficiently reproduced by planner-managers, the roles of entrepreneur, investor and speculator would be inseparable from private ownership, as speculators and investors would have a direct incentive through "expos[ing] their own wealth, their own destiny [...]". (Mises 1949: 709)

Ideally, Hayek states, the economic decision should be made by those who are directly affected by the gains and losses (1940: 140-1). Thus he regarded the system of planner-managers, in which these managers do not bear the full wealth effects of their decisions, as a 'pure illusion' (Hayek [1935], 1948: 176).

The Austrian answer to the debate about efficient allocation and price determination, respectively, is not the static approach of a Walrasian general equilibrium model, but a dynamic one focusing on the rapidly changing conditions of entrepreneurial action and counteraction (Mises 1949: 244-245).

The Austrians perceive the success of the economic system as inseparably intertwined with competition and the incentives attached to private property. (Cf. Kirzner 1984) The main concern of Mises and Hayek is the dynamic of the capitalist system which they perceive as a process of perpetual innovation through the pursuit of (temporary) monopoly profits. These are ground down by competition, the guarantee of efficiency. Competition is then not a means of reaching a static equilibrium but rather upsets the economic system for the sake of perpetual innovation and technical progress.

In contrast to the neo-classical analysis, the Austrian approach emphasises dynamism and imbalances, rather than being confined to a limited static context of full and efficient allocation of resources. Thereby, the Austrians address the important issues of technical progress and innovation.

Another achievement of the Austrian School is the recognition of the problems of limited and asymmetric information and of knowledge transmission. With his dispersed knowledge theory, Hayek incorporates the social process of knowledge transmission into economic analysis.

However, the virtue of introducing the issues involved does not guarantee the proposition of the Austrian school that private ownership is superior to public ownership. It is open to several objections. First of all, whilst dealing in depth with the costs and problems of bureaucratic co-ordination, the Austrians view the market as an all-embracing remedy. They largely ignore the full range of failures of the market mechanism, i.e. the provision of public goods, non-competitive markets and externalities, whether these derive from static or dynamic considerations. Because of their assumption of self-perpetuating competitive markets they downplay the problem of monopolies and monopolistic behaviour. Competition through open exit and entry to the sector concerned is regarded as the guarantee of efficiency. In this context sunk costs are neglected, and no differentiation is made between natural and artificial monopolies. This view of monopolies is particularly difficult in the context of previously centrally planned economies where the problem of monopolies is most urgent (cf. Snyder 1993). Thus the Austrian school fails to balance market against government failures.

A second important criticism is that in their discussion of the incentives given by private ownership, the Austrians have a rather naive concept of the 'classic firm', where the full wealth effects of the decisions he/she takes accrue to the owner-manager. The reality is that in most modern private firms, ownership and control rights are separated, and agents are making decisions on behalf of the owners and not only in 'daily business routine' matters. The resultant principal-agent problems in privately owned firms, due to imperfect and asymmetric information,¹⁴ are thus comparable to those in publicly owned firms. They are inadequately taken into account.

Third, the Austrians idealise the owner-manager and they over-estimate the incentives for the long-term development of their enterprises. When owners manage, their short-term private consumption interests might interfere with the need for reinvestment of revenues for long-term growth. This is particularly a problem in previously centrally planned economies, where the economic agents feel the need even more to make up for foregone consumption. A historical example is how British industrial enterprises, despite comparative advantages, failed to keep up with their German and American competitors in the decades before World War I and after. Chandler (1993) names as one reason the fact that British enterprises were largely still managed by their owners. In contrast, German and American enterprises had more sophisticated managerial structures with salaried managers - often with little equity in the enterprises - making critical investment and operating decisions (*ibid.* 315-19). Historical evidence suggests that, for the long-term efficiency of enterprises, skilled entrepreneurship and corporate governance outweigh the value of the incentives attached to ownership.

Fourth, the problem of dispersed knowledge has greater implications for optimum firm size than for ownership (*cf.* Rowthorn and Chang 1993: 57-8). The difficulty of dispersed knowledge arises in both public enterprise management as well as in the management of large private enterprises. Rowthorn and Chang (1993) look at large organisations, both private and public, and take into account

¹⁴ For reviews, as well as further references to principal-agent problems see Jensen and Meckling (1976), and Stiglitz (1987).

informational advantages and disadvantages of scale and scope in both production and distribution. They conclude that, the real issue is the determination of:

the ideal mix of decentralized and centralized forms of knowledge utilization - that is, between spontaneous interaction among independent units through the market and hierarchical interaction within one organization. (ibid.: 58)

Fifth, productive entrepreneurship, i.e. "the capability required to continuously upgrade and improve product structure, enhance the quality and availability of goods and services, adopt and adapt frontier technologies and reach new markets" (Kozul-Wright 1992: 18), is simply presumed to be available. Neither its origin nor its evolution is adequately explained, except for the unconvincing reference to individual motivation based on envy and greed or other natural propensities. Entrepreneurship and 'organisational capabilities' (Chandler 1993) have to be acquired and constantly adapted in a long process of learning-by-doing. This process of learning develops transferable knowledge, which can be used also in other firms as well as through product- and process-specific skills. The development of knowledge and skills is inseparable from their organisational setting, involving worker participation and general co-operation within the organisation. Moreover, it is inseparably intertwined with the overall institutional framework in which individual and collective economic activity takes place. Especially in the context of an institutional hiatus in the previously centrally planned economies, it becomes quite apparent that special emphasis has to be given to the fostering of productive entrepreneurship rather than to the ownership issue as such (cf. Chandler 1992 and 1993).

Sixth, the Austrian school exclusively relies on price information, in conjunction with the individual motivation given through private ownership, for efficient resource allocation. Other sources of information, and channels through which these are revealed, are ignored. Some of these are far too complex to be detected and processed by the market, most eminently intra-organisational processes. Despite opposition to the neo-classical paradigm and a recognition of the problem of dispersed knowledge, the Austrian school conceives firms as simply functioning in production, exploiting opportunities given through asymmetric information. They disregard the importance of intra-organisational

processes of utilising information and knowledge held by individual workers and networks, which are not owners and which enhance efficiency (cf. Brabant 1993: 174).

Seventh, competition does not necessarily depend on private ownership. Rowthorn and Chang (1993: 58) argue that effective product market competition combined with financial discipline of the enterprises involved can generate the information necessary regardless of whether there is private or public ownership.

Eighth, there are a number of circumstances in which public are superior to private enterprises (cf. Greenwald and Stiglitz 1986; Sappington and Stiglitz 1987; Shapiro and Willig 1990). Reasons for the establishment and operation of public enterprises are particularly brought up and widely discussed in the development literature and are also applicable to previously centrally planned economies. Those mostly mentioned are the provision of public goods; incomplete and underdeveloped capital markets, which require the state to carry out projects which are too large to be financed by the private sector; distributional and equity arguments; and macro-economic considerations like mitigating high levels of unemployment (cf. Chang and Singh 1993). In the previously centrally planned economies special attention should be placed upon the problem of profound uncertainty and institutional instability and its consequences for private investment in long range projects. In all these countries massive industrial restructuring efforts¹⁵ are required in order to continue the operation of existing enterprises, establish new enterprises and raise efficiency in the long-run. It is questionable whether private investors have enough faith in the future, and whether adequate funds for investment can be raised under the present conditions of complete uncertainty due to the political and economic crises in most of these countries. The high levels of capital flight and the prevalent short-termism of

¹⁵ The massive industrial restructuring effort which has to be undertaken can be illustrated for example by the shares of output in industries with negative value-added at quality-adjusted world prices calculated by Hughes and Hare (1992a and b). These were in 1989 for Bulgaria 50.8 %, for Czechoslovakia 34.8 %, for Hungary 34.6 %, for Poland 8.4 % and for the USSR 22.3 %. See also, for example, Gates, Milgrom, and Roberts (1994), Hesp (1994), Mann (1991), Prasnikar, Svejnar, and Klinedinst (1992) and Richet (1993).

private investment in many of these countries seems to indicate otherwise.¹⁶ A classic exposition of this argument is given by Kaldor (1980: 6-7):

[...] when public investment is part of a national plan it is possible to take into account all kinds of criss-cross effects (or indirect effects) which would not be possible with private investment. Keynes once said that in the face of complete uncertainty investors generally rely on a convention that the future will be just like the present, and for that reason 'the effects of the existing situation enter, in a sense disproportionately, into the formation of long term expectations'. Hence capacity is only likely to be created in so far as its use appears to be profitable at the existing state of incomes which are generated in production, the additional production generated in the future by the sum of the investment decisions of the present will itself increase the demand of commodities in comparison with the present level - a factor which private investors cannot take into account (or can do so only imperfectly) since they take their decisions independently of each other. Investment by public enterprises, on the other hand, can take the comprehensive effect of all investments into account in judging the social profitability of any particular investment project. It should be noted, however, that a state plan is capable of doing this even when the investment is undertaken by private enterprises, as the Japanese example shows. What is required is that there should be a fairly comprehensive state investment plan for industrial development, and the state should be capable of giving effect to this plan, though the 'administrative guidance' of the privately-owned firms - provided that, as in Japan, these are native and not foreign-owned firms.

Ninth, the Austrian school's belief in the co-ordination through unfettered markets ignores that perfectly competitive markets are fictional and the assumption of the purely individualistic acting homo-economicus is unrealistic. Under the real-life conditions of the previously centrally planned economies, it is hardly foreseeable that pure individualism will both maximise community welfare and forestall social conflict. The underlying libertarian philosophy of the Austrian school is particularly damaging if it is used as the sole guideline to foster an environment conducive to change (cf. Brabant 1993: 175).

Tenth, the Austrian school takes the functioning of markets, i.e. their capability to co-ordinate self-interested individual actions, as almost naturally

¹⁶ See for example, Financial Times, June 27, 1994 p. I-VIII.

given.¹⁷ They neglect that markets themselves are a set of socially constructed institutions, which enforce competition and limit the set of possible actions of individual and collective economic agents (cf. Kregel 1990: 47)¹⁸. Institutions such as the legal framework, the banking and financing system, the tax system, the labour market, and less intangible attitudes, routines and norms of behaviour define the context in which economic behaviour takes place. The co-ordination of economic decisions and their outcome depend entirely on the configuration of these institutions. In the context of previously centrally planned economies, the main emphasis has to be given to the conscious rearing of an adequate institutional framework. This will have to take into account the institutional legacies which vary from country to country. Under the existing conditions of profound uncertainty and institutional instability, the promotion of pure individualism and, the reliance on evolutionary change preached by the Austrian school will reinforce rent-seeking behaviour, resulting in redistributive strategies and destruction of resources.

1.2 Property Rights Theory and Private Ownership

The analytical framework of the property rights theory is often used when positing the favourable role of private ownership, hence justifying privatisation. Thus, the following questions will be considered; how private ownership is supposed to

¹⁷ The Austrian school, most prominently Hayek, views the market as an institution grown through centuries of evolution (Hayek 1944). He rejects 'constructivist rationalism' (Hayek 1979), i.e. the idea of conscious learning and intentional change of institutions. He sticks closely to his analogy of the biological evolution characterised by the lack of conscious planning (cf. Chang 1994: 73).

¹⁸ For a fuller discussion of the role of institutions, see Hodgson (1988), Matthews (1986) and North (1990).

generate a more efficient outcome¹⁹ and what problems are there in applying the framework to economies in transition.

Contrary to the Austrian school, the property rights school remains within the neo-classical tradition. Its contribution extends the neo-classical theory by the penalty/reward structure of property and contracting rights and consideration of positive transaction costs. The central proposition of property rights theory is that:

[..] the content of property rights affects the allocation and use of resources in specific predictable ways. (Furubotn and Pejovich 1972: 1139)

The value of a physical commodity is determined by the bundle of rights attached to it, which itself consists of a mix of components (Demsetz 1967: 347; Furubotn and Pejovich 1972: 1139). The sum of these rights is defined as property rights. The right of ownership as one category of the general concept of property rights contains

(i) the right to use an asset (*usus*), (ii) the right to capture benefits from that asset (*usus fructus*), (iii) the right to change its form and substance (*abusus*), and (iv) the right to transfer all or some of the rights specified under (i), (ii) and (iii) to others at a mutually agreed upon price. (Pejovich 1990: 28)

As in the Austrian School, private ownership rights, and especially their exclusivity and transferability, are regarded as the essential source of incentives for efficient resource allocation. Pejovich (1990: 42) propounds almost as a principle:

Both the right of ownership and contractual freedom generate incentives for utility-seeking individuals to identify, negotiate, and execute contractual agreements that [...] tend to move resources to their highest-valued uses.

¹⁹ The property rights theory is mainly concerned with x-efficiency, in terms of "slack" due to wastage or managerial incompetence. It widely neglects the problems of allocative inefficiencies due to exploitation of market power, public goods and externalities and distributional equity. Private ownership rights and contractual freedom are almost axiomatically seen as guarantors of allocative efficiency (Pejovich 1990: 35-43). The property rights school has drawn upon the Coase theorem (Coase 1960) and its continuing debate about advantages of private and state co-ordination of the internalisation of external effects. Most interesting are the game-theoretic examinations of the Coase-theorem, which consider transaction and information costs (Cf. Arrow 1978; Farrell 1987; Myerson and Satterthwaite 1983).

Pejovich argues that the penalty/reward system created through the owner-manager bearing the full wealth' effects for their entrepreneurial decisions, is not given for public officials, as they would neither bear the entire cost nor enjoy the full benefits resulting from their actions (1990: 33).

In their residual claimant theory,²⁰ Alchian and Demsetz (1972) attempt to justify the classic capitalist firm with its owner-manager exercising full ownership rights.²¹ Their departure point is the problem of 'metering' individual productivity and reward in team production. They propose as a solution that someone specialises as a monitor²² to make sure that the members of the team work efficiently, i.e. minimise 'shirking' (op.cit.: 778). In order to overcome the problem of 'who will monitor the monitor' an additional incentive in the form of the residual claimant status has to be made to the monitor (op.cit.: 782).²³ It is assumed that only private ownership can give the incentive to the 'monitor' to take a maximum monitoring effort and hence guarantee efficiency of team production. The residual claimant theory is generally put forward to posit the superiority of private over public ownership.

Proponents of the property rights school generally propose that managers of state-owned enterprises have weaker incentives than owner-managers. They claim "soft budget constraints" and the problem of self-seeking agents would make public enterprises more x-inefficient than private ones:

Private enterprises are subject to the discipline of the market and must respond to market signals to survive. Managers of public firms, on the

²⁰ Alchian and Demsetz (1972) have produced the most widely known variant of the residual claimant theory. For other variations see DeAlessi (1982) and Grossman and Hart (1986).

²¹ The bundle of rights contains: "1) to be a residual claimant; 2) to observe input behaviour; 3) to be the central party common to all contracts with inputs; 4) to alter the membership of the team; and 5) to sell these rights" (Alchian and Demsetz 1972: 783).

²² Alchian and Demsetz (1972: 782) use 'the term monitor to connote several activities in addition to its disciplinary connotations. It connotes measuring output performance, apportioning rewards, observing the input behaviour of inputs as means of detecting or estimating their marginal productivity and giving assignments or instructions in what to do and how to do it. It also includes[...] authority to terminate or revise contracts'.

²³ One variation of the residual claimant theory is that the member of the team should be made owner who contributes the highest asset specificity (cf. DeAlessi 1982: 194; Grossman and Hart 1986). Another variation suggests that the member whose activity is most difficult to evaluate should become owner (cf. Holmstrom and Tirole 1989: 73-74).

other hand, are less constrained by market considerations, and find it easier to obtain subsidies and mask utility-maximizing behaviour under the guise of fulfilling other social goals. Indeed, public enterprises, for long periods endowed with politically influential clients, can survive for long time periods, and their managers prosper, even in the presence of persistent losses. (DeAlessi 1982: 205-6)

DeAlessi (1969; 1973; 1980) argues that the non-transferability of ownership rights of public enterprises impedes the public at large from specialising in this activity, and hence their incentives to monitor the managers are reduced.²⁴ According to DeAlessi managers of both public and private enterprises increase their utility through expanding the resources under their supervision.²⁵ And even if the principals (the public) as owner of the enterprises seek to monitor their agents (the bureaucrat-managers), the costs of doing so would be prohibitively high due to imperfect and asymmetric information (DeAlessi 1982: 205).²⁶

In short, the property rights theory recognises that ownership influences and determines the behaviour of economic agents. Proponents of the theory stress that private property rights give essential incentives for efficient economic behaviour. They understand production as more than a purely engineering process. They are aware of conflicts between individual economic agents in production and of the problems of self-seeking individuals, and imperfect and asymmetric information. Thus, the property rights theory is a noteworthy enhancement to the traditional neo-classical analysis where ownership is irrelevant in the efficient allocation of scarce resources. However, the proposition that private ownership generates a more efficient outcome can be criticised on the following grounds.

²⁴ One related argument is that of Aristotle proposing that common property would not be regarded as 'belonging to us all' but as 'belonging to no one'. Thus unless in this case the enterprise would be owned as private property, it would be neglected.

²⁵ DeAlessi (1969) mentions bureaucratic lobbying, interest groups' pressure and camouflaging relatively unproductive investment projects through unrealistically low discount rates as ways of managerial self-aggrandisement.

²⁶ DeAlessi (1969) perceives enterprises producing non-marketable goods as particularly under danger of this kind of managerial discretion. Public sector defence through monitoring would 'fail for the use of benefit-cost data to justify the ranking of nonmarketable investments may best be viewed as an ex post rationalisation of the ranking yielded by the decision maker's preference function as constrained by his opportunity set' (op.cit.: 15).

First, the property rights theory is built on the assumption that the only significant motivation for efficient economic behaviour is material self-interest, given through private ownership rights. Rowthorn and Chang (1993: 56-57) argue that the very existence and enforcement of a property rights system depends on a functioning moral value system, as 'otherwise the enforcement costs would be prohibitively high' (ibid.). With rising division of labour within industrial organisations, the number of individuals with significant discretion increases as well. An indomitable monitoring task would arise if all these organisational participants acted out of pure material self-interest. In fact many other motivations play a role in their behaviour, e.g. organisational loyalty,²⁷ work ethic, moral convictions, delight in work and job satisfaction. The property rights theory reduces the motivation of a holder of the ownership rights to the aspect of material self-interest, and overlooks the motivation of those involved in the production process. The wide range of theoretical and empirical literature on managerial and worker motivation is entirely neglected.²⁸

Second, the question of ownership has in some industries implications for these managerial and worker motivations. Public ownership can infuse 'an ethic of public service' in some industries, particularly in those producing public goods (Fine 1990: 127). This notion of provision of collectively beneficial services in public enterprises can create additional incentives and motivation for employees.²⁹ The whole approach to production in a 'public service' enterprise is different to a private profit maximising enterprise. Moreover, objectives like job creation, infant

²⁷ On the role of organisational loyalty, see Hirschman (1970) and Simon (1991).

²⁸ There is extensive theoretical and empirical literature which deals with individuals within organisations in terms of their beliefs, values and their relations with one another. Without claiming to be exhaustive some important references are mentioned below. The human relationship approach, based on the famous Hawthorne experiments (1924-1932) at the Western Electric Company in America is one of the theories, concentrating upon the people dimension and their interrelation within organisations (cf. Mayo 1971; Roethlisberger and Dickson 1939). See Herzberg (1966) on the motivation and 'hygiene' or 'maintenance' factor. See McGregor (1960) on the importance of the style of management on the operation of an organisation. See Argyris (1957) on the importance of self-actualisation; Homans (1950) on individual behaviour in social groups; Dawson (1988) on the role of professional groups; and Schein (1987) and Handy (1985) on organisational culture.

²⁹ See for example Kakabadse (1982), who examines culture in a social service department.

industry protection, restructuring and the pursuit of R&D, can be better targeted in public than private enterprises. Objectives, attitudes, incentives and motivation would be altered and abandoned in case of privatisation and the shift towards the exclusive goal of profit maximisation. The concept of national industries could have positive connotations for economies in transition, with their attributes of adverse macroeconomic conditions, instability, uncertainty, and requirement of sacrifices and initiatives. Managers and workers might be more motivated to undergo and participate in the huge restructuring processes and be more inclined to make sacrifices for the future of national industries and national benefit, rather than for the benefit of private owners.³⁰

Third, proponents of the property rights theory stress the susceptibility of public enterprises to soft budget constraints. However, large private enterprises are as much subject to soft budget constraints, due to state intervention, e.g. direct and indirect subsidies, and restrictions on entry. Stiglitz points out that soft budget constraints can also arise from the financial system, providing examples from the United States (Stiglitz, 1993: 190). He stresses the problem of inter-firm credits as a further source of soft budget constraints as particularly serious in previously centrally planned economies. He has doubts about the effectiveness of privatisation as a means to impose hard budget constraints:

[...] privatisation is no panacea, no protection against protection and subsidies. What privatisation does is to increase the "transactions cost", to use the fashionable phrase, of obtaining government subsidies and government protection from competition. (Stiglitz, 1993: 187)

Soft budget constraints are also a phenomenon inherent in vertically and horizontally integrated enterprises. Given "bounded rationality"³¹ and imperfect and asymmetric information, the determination of internal transfer prices is subject to discretion; thus it is open to manipulation. Both manipulated transfer prices and other cross subsidies can soften the budget constraints of individual subsidiaries.

³⁰ Fine (1990: 130) notes that nationalisations occurred historically in the UK after the second world war, as a result of the unprofitable state of these industries and their need for large-scale restructuring, which could not be achieved by private owners.

³¹ On the concept of bounded rationality, see Simon (1982).

Fourth, the property rights school assumes that property rights can be clearly defined and enforced once and for all. However, the very definition of property rights is subject to a constant power struggle between different factions in society. As such the property rights and their content are continuously changed. For example, the relaxation of industrial law, such as dismissals protection regulation or the enforcement of environmental protection laws, have immediate consequences on the property rights of an enterprise. The process of definition and redefinition of property rights is very complex and has to be seen in its social and political context. In the setting of previously centrally planned economies the power struggle between old and new elite, and subversive elements such as the mafia, have to be taken into account. Besides, the commercial and legal environment, and the general market infrastructure are either non-existent or very poorly developed. This includes social welfare provisions like unemployment benefit. In previously centrally planned economies, enterprises made extensive provision for their employees, e.g. free meals, access to special stores, child care and education, health care, social clubs, vacation resorts, and most important, job security. The alteration of property rights often has the consequence of withdrawing these obligations from the employee. This can lead to severe social unrest. Thus, the social acceptability has to be taken into consideration when property rights are altered.

Fifth, the residual claimant theory justifies ownership by the classic capitalist firm being assigned the role of the 'specialised monitor', as this would give her/him an incentive to put in maximum monitoring effort, hence guaranteeing efficiency of the production. The theory assumes that monitoring is the key activity which can mitigate inefficiency. However, depending on the production process there are other activities which bear significant control, and it is equally important to ensure that the corresponding agents do not exploit their

room for discretion.³² On these grounds, one could argue that any member of the team should have a share in the ownership rights of the firm according to his/her importance for overall efficiency (cf. Rowthorn and Chang 1993: 55).

Sixth, the property rights theory points out the problems of self-seeking behaviour, asymmetric and imperfect information and, hence the inability to monitor agents thoroughly in public enterprises. However, these problems are a result of the separation of the rights of ownership and control, and they arise regardless of ownership. The majority of modern private firms have widely dispersed private ownership with most rights of control and decision delegated to professional managers. The problem of self-seeking behaviour in private firms, i.e. managers who devote their energies and the firms' resources into entrenching themselves, and into promoting their own careers and interests, is widely acknowledged (cf. Hannaway 1989; Milgrom and Roberts 1988; Schleifer and Vishny 1989). Individual shareholders as well as individuals of the public as principals, who are not directly involved in the production process, face the problem of incomplete and asymmetric information in their supervisory efforts.³³ Moreover, even if all necessary information were available, and, given

³² Barzel (1989: 56-59) suggests that agents should participate in the residual income according to the de facto control they exercise over the outcome of production. To the extent that control is based on idiosyncratic knowledge, one could interpret Barzel's proposition as suggestions that agents should be considered to participate in ownership to the degree of their idiosyncratic knowledge. Barzel's view does not support the case of the classic capitalist firm with its owner-manager. In his approach ownership does not necessarily have to be given to the main monitor, but could be assigned to a number of agents.

³³ Yarrow (1989) argues that the principal-agent problem in case of public enterprises is more severe due to the additional delegation layer, i.e. politicians and bureaucrats acting on behalf of the public. Self-seeking behaviour of politicians and the limits of the electoral system as a disciplinary mechanism would cause additional problems. Chang and Singh (1993: 52-3) counter convincingly in that: (a) the additional delegation layer for a single or a few agencies in case of a public enterprise might be more effective in monitoring managerial behaviour than fewer layers for a large group of shareholders; (b) every large-scale enterprise has multiple layers of delegation within itself, raising the question whether one layer more or less will make such a difference; (c) considering empirical evidence one cannot hold up the general assumption that every bureaucrat is a purely self-seeking individual.

shareholders own only a little share, they lack incentives to maximise their monitoring efforts.³⁴

Seventh, the argument of the property rights theory, that private ownership increases x-efficiency, is heavily based on the discipline imposed by the capital market and the market for managers. In the debate over principal-agent problems, four mechanisms, which work in conjunction with each other, have been identified which are supposed to restrict the managerial discretion of agents in privately owned firms.³⁵ Firstly, control is supposed to be imposed by the stock-market as described below.³⁶ Given perfect competition on product markets, when the performance of a firm becomes unsatisfactory, customers will switch to other products. On account of the lower profitability, shareholders will increasingly sell their shares, with a subsequent fall in share price, as supply exceeds demand. The lower share price could lead to a management shake-up, through new shareholder pressure and external take-over threats. This leads to the second disciplinary mechanism, external take-overs, which threaten to eliminate unprofitable firms.³⁷ The third disciplinary mechanism is that of the manager-employment-market. It is assumed that the employability of managers depends crucially on their present performance, which is reflected by the share price of their firms (Pejovich 1990: 57-64). Consequently managers who aspire to higher paid positions are

³⁴ Chang and Singh (1993: 52) call this problem, analogous to Olson (1965), 'shareholder collective action':

That is, when the shareholder group comprises a large number of individuals, no individual shareholder will have an incentive to collect relevant information and monitor his/her action, because the improved performance is a public good from which every shareholder will benefit without paying for it.

³⁵ The principal-agent problem is broadly discussed by various strands of the new institutional economics i.e. the property rights proponents (Cf. Alchian 1969; Alchian and Demsetz 1972; Furbotn and Pejovich 1972: 1148-1157 Manne, 1965), the principal-agent theories (Jensen and Meckling 1976; Fama and Jensen 1983) and theories on opportunistic behaviour (Williamson 1975; 1985).

³⁶ Pejovich (1990: 61) puts it this way:

Insofar as share prices reflect the present value of the expected future consequences of current managerial policies, market evaluation protects shareholders from a situation in which management has less concern for their wealth.

See also Alchian and Demsetz (1972: 788) and Furubotn and Pejovich (1972: 1150).

encouraged to maximise their efforts. Control through creditor financial institutions constitutes a further, fourth, disciplinary mechanism.

However, these mechanisms have the following shortcomings. First, the stock-market as disciplinary mechanism is based on the assumption of non-captive customers and on shareholders effectively monitoring their firms. In case of monopolies on the product market, customers cannot simply switch to another product, which significantly restricts share prices as performance-indicators (cf. Rowthorn and Chang 1993: 56). In previously centrally planned economies the majority of enterprises are monopolies.³⁸ Effective monitoring by the shareholders can be seriously weakened by the problem of 'shareholder collective action'. For monitoring by the shareholders can be seriously weakened by the free-rider problem and problems of high transaction costs (cf. Alchian 1969: 501; Alchian and Demsetz 1972: 788). Moreover, shareholders face the problems of imperfect and asymmetric information. As the assumptions of non-captive customers and of shareholders effectively monitoring their firms, are highly unrealistic, so is that of the effective functioning of stock-markets as a disciplinary mechanism. The problem is even aggravated in the context of previously centrally planned economies, as stock-markets are either non-existent or newly and poorly established.

Second, there is a fierce debate over external take-overs as a selection mechanism. Empirical evidence suggests that external take-overs are not confined to poor performers, that profitability does not rise after mergers, on average, and in case of increased monopoly power, allocative efficiency is reduced (cf. Chang and Singh 1993: 54). Singh (1971) points out that threats of external take-overs may even encourage firms to expand as a defence against take-overs, instead of preventing managerial self-aggrandisement. The disciplinary mechanism of take-overs is irrelevant in the context of previously centrally planned economies due to severely underdeveloped capital markets, as are the two remaining mechanisms.

³⁷ For a more detailed discussion of the take-over mechanism, see Firth (1979; 1980), Grossman and Hart (1980), Manne (1965), Meeks (1977), and Singh (1971).

³⁸ On the consequences of monopolisation see for example, Newbery and Kattuman (1992), and Snyder (1993).

Financial institutions are underdeveloped in previously centrally planned economies, and the majority are state-owned. Moreover, political considerations may dominate lending policies, which limits the effectivity of financial institutions as supervisor of their borrowers.

Concluding remarks

This chapter has looked at the theoretical underpinnings of the justification for privatisation. Two major theoretical frameworks were analysed within which the advantageous role of private ownership has been understood. It is apparent, that neither the Austrian school nor proponents of the property rights school provide a general case for the superiority of private ownership. The Austrian school posits the favourable role of private ownership only by discarding as irrelevant or leaving unconsidered those arguments that contradict their case. In particular, in correctly emphasising the dynamic and informational aspects of the economy, the well-known static inefficiencies of the market system are incorrectly set aside. Further, it is also erroneously presumed that disaggregated and individualised pursuit of advantage is superior to state intervention merely by virtue of introducing the problems of dynamism and imperfect information. In addition, the relevance of their general and ideal propositions to the functioning of specific economies in different historical periods and circumstances is itself open to question.

The property rights theory stresses the role of the penalty/reward system set up by private ownership for the efficient behaviour of the manager-owner, thereby ignoring the motivation of employees, other than as narrowly conceived utility maximisers. However, in the more common case of separation of the rights of ownership and control the theory builds on the discipline imposed by the capital market and the market for managers. As clarified above, there are strong theoretical and empirical reasons which suggest that these mechanisms may not work as specified. Hence the whole line of reasoning is seriously flawed. Additionally, their transferability to the setting of previously centrally planned economies is debatable, considering the mere absence or poor development of capital markets and their supporting institutions in most of the countries concerned. Furthermore, little understanding is shown for the complex process of

definition and redefinition of property rights within their social and political context.

As conventional economic theory seems to be unable to give any justification for why privatisation is supposed to enhance economic efficiency, the question will now be examined within the framework of political economy.

2. Privatisation: the path to enhanced efficiency?

Introduction

In the last chapter, a critical assessment was made of the economic analysis which supports the belief in the superiority of private ownership. It was argued that the theoretical underpinnings of such a belief are unsatisfactory. This chapter will examine whether a justification for privatisation can be realised within the framework of political economy. Aware of the sheer amplitude of concepts assigned under the rubric of political economy, the analysis will be confined to the concept of the budget constraint and that of structural change. This approach was also taken by Rowthorn and Chang (1993). However, here it is extended and specifically directed towards privatisation in the context of PCPEs and especially Azerbaijan. The concept of the budget constraint is often employed in the context of PCPEs.

In order to emphasise the long-term perspective which has to be taken in an environment requiring extensive restructuring, a distinction will be made between static and dynamic efficiency. The discussion on enterprise efficiency and privatisation often only considers the static perspective, which is inadequate for the volatile environment of PCPEs in which all parameters are bound to change.

In a further step this chapter deals with the process of definition and redefinition of property rights, also termed as contracting by the literature on institutional change (cf. Libecap 1993: 4). The analysis draws upon Libecap (1993), who analysed different property rights solutions to common pool problems encountered in exploiting natural resources in the United States. Here Libecap's analytical framework is adapted and extended to suit the context of privatisation issues in PCPEs. A major deficiency of the debate on privatisation in PCPEs is that the actual contracting for the proposed institutional change is widely ignored.¹ The following contribution tries to remedy this deficit.

¹ For an analysis of the contracting process in Azerbaijan, see chapter seven.

Finally, motives and goals are often blurred in the debate over privatisation in PCPEs. This can lead to conflicts and inconsistencies. The chapter tries to shed some light on this issue.

The first section examines institutional conditions responsible for soft budget constraints. The hypothesis is proposed, that the softness of the budget constraint is due to (a) a system of political control based on patronage;² and (b) the lack of appropriate corporate governance systems. The second section looks at aspects of structural change, placing emphasis on industrial restructuring. The third section considers the origins of property institutions and institutional change. The final section deals with inconsistencies and conflicts between different motives and goals of privatisation in PCPEs.

2.1 Static efficiency: budget constraint

2.1.1 What is the soft budget constraint?

The concept of "soft budget constraint" was coined by Kornai (1980) to explain the static inefficiency of enterprises in centrally planned economies. It occupies a key role in his analysis of shortage (1980: 299-322; 1986: 3-30).³ The latter focuses on the institutional structure of the society and ultimately links the permanent resource shortage of centrally planned economies directly to the social ownership of the means of production with its entrenched system of patronage.

² Patronage and clientelism are understood as interchangeable (cf. Willerton 1992: 249n1).

³ In Kornai's 'Economics of Shortage' (1980), the production side of the economy is examined, describing seller markets with shortage and buyer markets with surplus. The production in different economic systems is described as a problem of linear programming with system specific constraints (ibid.: 23). Three constraints are distinguished: the resource constraint, the demand constraint and the budget constraint (ibid.: 23-26). Whilst the resource constraint is given by the environment of the economic system, the two other constraints are determined by the institutions of the economic system. According to these constraints Kornai defines socialist economic systems as 'resource constrained systems' and capitalist economic systems as 'demand constrained systems' (ibid. 26-30).

For his purpose Kornai adopts the concept of the budget constraint as used in individual utility maximisation of neo-classical household theory (1980: 4). The budget constraint of an economic agent is given by his/her liquid and illiquid financial assets and it limits his/her expenditure in each period. Economic agents facing hard budget constraints have to finance their expenditures through their receipts and their stock of assets and bear full financial responsibility for their decisions. However, if economic agents can expect that expenditures exceeding their limits will be covered by subsidies or loans without their being bankrupted, they can lack costs- and rentability-consciousness and give way to self-aggrandisement. In other words their budget constraint becomes soft. A soft budget constraint reduces incentives for efficiency created through, e.g. the threat of bankruptcy or unemployment. Newbery (1990: 8) puts it thus:

There are few penalties for poor performance, and few rewards for good performance.

According to Kornai (1980: 311-314), the classic soviet type centrally planned economy faces soft budget constraints, i.e. lack of financial discipline, whilst the capitalist economies of the UK and the USA in the previous century are examples of the other extreme, i.e. economies exposed to hard budget constraints.

Kornai (1980: 562) considers soft budget constraints as inherent to the centrally planned system. He describes the consequence of soft budget constraints on the centrally planned economy as follows: management of firms are assumed to have a tendency towards expansion, as a bigger budget boosts their status (cf. 1980: 23, 61-63). Moreover, they face unpredictable future constraints, and high penalties are attached to an inability to meet physical targets. Thus their demand on resources (investments, labour, material inputs) under soft budget constraints is unlimited. Because of administrative prices firms do not adjust to the changes in relative prices, i.e. they lack costs- and rentability-consciousness. The function of money is reduced to a passive unit of account (1980: 306-309, 323-336; 1986: 9-11). The price system has no allocative function (1980: 323-376, 513-529). In an economy under a soft budget constraint there is the tendency to hoard goods, and shortages are reproduced accordingly: "shortage breeds shortage" (1980: 286).

The role of the soft budget constraint in the explanation of shortage has been debated in a more general discussion of whether they also exist in capitalism without necessarily causing shortages. Thus, the concept of soft budget constraints seems to be more able to explain inefficiency than shortage (cf. Gomulka 1986: 73-90; Hare 1989: 49-81). However, a detailed discussion of Kornai's analysis of shortage and its validity is beyond the scope of this work. The aim of this section is to analyse the conditions under which soft budget constraints arise. Thus, in the following, the soft budget constraint will be understood as a non-binding budget constraint which creates a disincentive to economise on resources, i.e. lack of financial discipline. It will be analysed mainly in the context of previously centrally planned economies.

There are several institutional conditions responsible for the existence of a soft budget constraint for enterprises, in conjunction or on their own (cf. Kornai 1980: 302-307; 1986: 5-6). First, administrative determination of output prices and production quantities can strengthen the bargaining position of enterprises towards the central planning commission concerning the budget softness. Moreover, both administrative prices and quantities and implicit input subsidies (e.g. low energy prices) distort any decision making on production based on cost analysis and hence limit financial discipline. In most previously centrally planned economies most prices were ultimately liberalised except for essential consumer goods and services and energy prices. In Azerbaijan controls on most prices (except for prices of some services, some foodstuff, medicine, and energy) were lifted in January 1992, in line with the CIS-wide policy of price liberalisation.⁴

Second, high and growing direct subsidies to enterprises were a key problem of centrally planned economies and constitute another indicator of soft

⁴ On the quantification of implicit subsidies through low energy prices in Eastern Europe, see Hughes and Hare (1992).

budget constraints.⁵ It is argued that in most cases there is no reasonable economic nor social justification for these subsidies and that well-organised political influences of heavy industry and the military-industrial complex play an important role in their arrangement (cf. Welfens 1992: 60-62). However, for the confirmation of this argument it is necessary to analyse data and information at a more disaggregated level than the mere volume of direct subsidies. The justification for subsidies has to be judged by the objectives of the underlying policy and the possible policy alternatives for reaching the goals intended by granting these subsidies. As far as the budget softness is concerned, the granting of subsidies is not so much the problem as the "lack of a 'normative' or legally binding set of rules, and the consequent need to consider each case on its merits and engage in bilateral bargaining" (Newbery 1990: 8). If the allocation of subsidies is arbitrary and open to political manipulation, enterprises are under no pressure to improve performance, as they expect to be bailed out by the state when they fail. Their budget constraint is soft. In the adjustment process, the persistence of this kind of budget softness constitutes a particularly grave problem. Forward-

⁵ Holzmann (1991) exposes the budgetary subsidies of some Central and Eastern European economies:

Country		1980	1985	1988	1989
Bulgaria	1	13.3	11.9	19.1	17.8
	2	1.2	1.4	1.6	1.6
	3	12.1	10.5	17.5	16.2
	4	4.2	5.3	8.3 ^c	3.0
CSFR	1	8.7	11.8	13.0	16.1
	2	2.3	5.5	5.8	7.7
	3	19.8 ^a	6.3	7.2	8.3
	4	9.0 ^b	1.9	2.5	1.8
Hungary	1	9.7 ^b	17.1	14.0	12.6
	2	5.0 ^b	7.1	5.7	7.2
	3	28.7	9.9	8.2	5.4
	4	9.8	5.4	5.6	4.0
Poland	1	18.9	16.5	17.0	17.1
	2	6.7	7.3	9.0	7.4
	3	19.5 ^a	9.2	7.9	9.8
	4	1.4 ^a	3.6	2.2	1.2

1 budgetary subsidies relative to GDP

2 consumer subsidies relative to GDP

3 subsidies to enterprises relative to GDP

4 subsidies for foreign trade relative to GDP

^a 1981 estimate

^b 1982 estimate

^c 1987 estimate

Source: Holzmann (1991)

looking SOEs and newly developing private enterprises are deprived of necessary funds, whilst resources are allocated to ensure the survival of inefficient adjusters.

In 1991 budgetary subsidies to enterprises and financial institutions in Azerbaijan comprised 1,541.2 million roubles and constituted 14.5 per cent of the total budgetary expenditure (IMF 1993: 68). The Minister of Finance was unwilling to give any information on budgetary subsidies to enterprises. According to the interviews held by the author with employees of the Cabinet of Ministers, the Ministry of Economics and several enterprises and corporations (April 1994), most enterprises do not receive any direct subsidies. However, credit at negative real interest rates is available for many enterprises.

One has to note, however, that softening of budget constraints through direct subsidies is prevalent in capitalist economies. The state in market economies often subsidises public as well as private companies or protects them from adverse shocks in light of social, distributional or environmental objectives. In many cases, state assistance is attained through various interest group pressures. Some of these subsidies are justified on welfare grounds, although alternative means of achieving the political objectives might lead to a socially superior outcome. In case of 'regulatory-capture' private enterprises themselves might capture the state regulatory agency to obtain soft subsidies and protection.⁶ As already mentioned, soft budget constraints can be also a problem in highly vertically and horizontally integrated enterprises in advanced capitalist economies regardless of ownership. Individual subsidiaries' budget constraints might be softened through favourable internal transfer prices and cross subsidies from other subsidiaries. Bounded rationality (Simon 1982) and imperfect and asymmetric information within such big organisations are causes of such internal soft budget constraints.

Third, softness of the budget constraint can also be caused through discretionary administration of taxation. Discretion may arise through

manipulation (e.g. inflating costs or hiding profits), complete evasion and corruption. Needless to say, the poorly developed institutional environment of previously centrally planned economies lacks information and control mechanisms and a legal framework to deal with tax evaders and corruption, and hence offers a perfect arena for all kind of tax fraud. Most tax administrations are newly established and tax codes are still only in the earliest stages of development.⁷

According to officials in the state tax inspectorate in Azerbaijan (March 1994), complete tax avoidance occurs only in small (i.e. five and less employees) private businesses (e.g. shops). However, 68 per cent of all taxable enterprises were at the time in tax arrears with on-going controversies over the extent of their tax debts.

Fourth, soft budget constraints can also arise from the financial system. This is the case both in previously centrally planned as well as in advanced capitalist economies.⁸ The availability of credit, often at negative real interest rates, and in many cases granted arbitrarily, is regarded as most important determinant of soft budget constraints (cf. Raiser 1993: 258). 'Creditor passivity', i.e. banks reluctant to enforce debt contracts, is regarded as a further explanation for soft budget constraints (Begg and Portes 1992: 398).⁹ There are a number of reasons given in the literature for government's and bank's reluctance to curb credits to loss-making enterprises.¹⁰ First, governments may wish to keep inefficient enterprises going because of the vast social consequences of their

⁶ The term 'Regulatory-capture' was coined by the Chicago school, most notably by Stigler (1975). A core assumption of the theory is that regulation is favourable for producers. Stigler (1975: 114) puts it: "regulation is acquired by the industry and designed and operated primarily for its benefit". 'Regulatory-capture' arises, when producer interest groups obtain subsidies and protection (e.g. entry restrictions) merely through their political power, and hence without economic or social justification.

⁷ Raiser (1993) stresses tax deferments as an indicator of soft budget constraints in the transitional Polish economy.

⁸ Stiglitz provides examples from the United States for soft budget constraints due to the financial system (1993: 190). There is extensive theoretical and empirical literature on financial markets and their imperfections in previously centrally planned economies. See, for example, Begg and Portes (1993).

⁹ The term 'creditor passivity' was coined by Mitchell (1992) and adopted for the context of previously centrally planned economies by Begg and Portes (1992).

¹⁰ For reasons for 'credit passivity' and allocation of credits to bad performers, see, for example, Raiser (1993), and Begg and Portes (1993).

closure and the inability to start a necessary restructuring process.¹¹ Secondly, institutional imperfections of the banking system make effective monitoring impossible and allow credits to be allocated in an arbitrary way, i.e. not considering the creditworthiness of enterprises. This is down to personal links between enterprise managers and bank directors or outright corruption. In the context of these institutional imperfections, monetary austerity, i.e. high interest rates and tight money supply, as demanded by most "stabilisation" programmes, might lead to perverse results (cf. Bofinger 1992). Instead of tightening the budget constraints of inefficient enterprises and forcing them to adjust they might withhold vital resources for the restructuring process and for newly emerging businesses (cf. Raiser 1993).¹²

Fifth, the problem of inter-enterprise debts is often regarded as a further source of soft budget constraints in previously centrally planned economies (cf. Raiser 1993: 258).¹³ Whilst this form of credit was almost non-existent, due to the centrally planned allocation system, it has sharply risen in a number of previously centrally planned economies.¹⁴ One has to note, the sharp rise of inter-enterprise debts is partially due to the new direct contact between enterprises, a common feature in advanced capitalist economies. In the FSU the breakdown of bank

¹¹ Begg and Portes (1993: 403-404) suggest that rather than leaving loss-making enterprises to go to the banks, their losses should be converted into a fiscal claim. Instead of non-transparent indirect subsidies from the banking sector, explicit fiscal subsidies should be given out. They should be confined to an immutable amount and granted with greater transparency. Moreover, subsidy claims should be considered in framing budget projections.

¹² Begg and Portes (1993) suggest various possible policies to alleviate credit market failures and reform overall credit relations in previously centrally planned economies; for example selective credit controls, recapitalising banks and enterprises, and various fiscal policy measures.

¹³ See Rostowski (1993) on inter-enterprise debts.

¹⁴ According to Rostowski (1993) the problem of inter-enterprise debts is particularly severe in the FSU and Romania compared to the Central European previously centrally planned economies.

payments mechanisms is another reason for this rise.¹⁵ However, the unavailability of reliable disaggregated data on both inter-enterprise and bank debt arrears, makes it impossible to evaluate the nature of the latter, i.e. impossible to 'distinguish healthy expansion of inter-enterprise debts from the pathological (or excessive)' (Rostowski 1993: 150).

In Azerbaijan credit at negative real interest rates is available for many enterprises. Several officials interviewed (April 1994) gave the impression, that the granting of credits is arbitrary and down to the political bargaining power of managers of enterprises. Moreover, there are neither clear performance requirements nor adequate monitoring of the managers attached to these credits.

Sixth, the mere non-existence or relative infancy of bankruptcy law and policy is another cause of prevalent soft budget constraints in previously centrally planned economies. The enforcement of bankruptcy law serves three purposes (cf. Gray 1993:1). First, it sets clear and binding rules and procedures for exit of firms. Second, it protects creditors and serves as an ultimate means of debt collection. Hence it facilitates flow of credits. Finally, it stimulates the restructuring of financially distressed enterprises by specifying reorganisation schemes and conciliation procedures between debtors and creditors. The credibility of the bankruptcy law is essential for increasing financial discipline and securing viable debt collection. The existence and implementation of bankruptcy law in previously centrally planned economies is therefore important for both public and newly emerging private enterprises.¹⁶ However, bankruptcy policy dealing with insolvent public enterprises has to emphasise restructuring and protection of assets during this process. Liquidating the bulk of loss-making enterprises would cause massive economic, social and political disruption, and is therefore not feasible.

¹⁵ The breakdown of the bank payments mechanisms and the weak new banking system leads to long delays in inter-republican as well as republican payments (Rostowski 1993). Moreover, harsh banking regulations prevent enterprises from withdrawing deposits in cash with few specified exceptions. Cash can be withdrawn for the payment of wages, but not for the payment of supplies, machinery and equipment. Many enterprise managers interviewed in Azerbaijan (1993) complained that although they had money on their accounts they could not put it to the best use, as they were not allowed to withdraw it. Most suppliers in other republics demand payments in hard currency.

¹⁶ For an exposition of first experiences with bankruptcy law and policy in previously centrally planned economies, see Mizsei (1993) and Gray (1993).



Simple transfer of judicial bankruptcy proceedings from capitalist to previously centrally planned economies is not sufficient considering the weak judicial systems in the latter. Even if adequate bankruptcy law were adopted, judicial bankruptcy proceedings would be impeded by shortage of judges and qualified trustees and liquidators and the poor development of the legal periphery (e.g. contract enforcement, accounting standards and fiduciary liability) and underdeveloped capital markets.¹⁷ Moreover, whilst judicial bankruptcy procedures in capitalist economies constitute an exception and a last resort of debt collection and reorganisation of financially distressed enterprises, they will have to be applied to a significant part of enterprises in previously centrally planned economies (Gray 1993: 1).¹⁸ Besides bankruptcy law, special schemes and rules have to be developed and implemented for out-of-court settlements, as they are also likely to become more relevant in the light of the complexity of the restructuring process (cf. Mizsei 1993). In Azerbaijan the adoption of a bankruptcy law was still pending by June 1994.

In short, there are a number of institutional conditions responsible for the existence of a soft budget constraint for enterprises. Some are still prevailing from the days of central planning. Others have particularly arisen in the transition period. In order to harden the budget constraint one has to understand why these institutional conditions exist. The above analysis implies that concentration on ownership structure per se is not sufficient for the successful hardening of the budget constraint. It suggests that the prevailing of these institutional conditions allowing soft budget constraint can be only understood within the context of political economy.

¹⁷ In late 1991 a strict law was adopted in Hungary, requiring enterprises to file for bankruptcy after ninety days of insolvency. The result was a skyrocketing number of bankruptcy filings amounting to 14,300 enterprises (4,400 as reorganisations and 9,900 as liquidations, producing an estimated one-quarter to one third of Hungarian GDP) in 1992. That the judicial system was not prepared for such a task can be seen in the Budapest court, where eight judges were handling about 4,000 cases in mid-1992 (Gray 1993: 3).

¹⁸ Gray (1993: 2) remarks that the reason for satisfactorily functioning judicial bankruptcy procedures in advanced market economies is that they operate at the margin.

2.1.2 The Politics of the soft budget constraint

As mentioned above, proponents of privatisation link the existence of soft budget constraints to the lack of costs- and rentability-consciousness and the tendency for self-aggrandisement by public enterprise managers caused by public ownership, particularly in the setting of CPEs and PCPEs. On the contrary, here, the following hypothesis is proposed: the softness of the budget constraint is due to (a) a system of political control based on patronage; and (b) the lack of appropriate corporate governance systems.

2.1.2.1 *Patronage*

Patronage can be defined as informal ties and networks of "individualised, reciprocal, political relations" (Willerton 1992: 6).¹⁹ In a political system based on patronage, leading politicians and bureaucrats - the patrons - are building coalitions of protégés and clients enabling them to consolidate their power. In return, the patrons incorporate their clients' interests into their policy making. Patronage can be in operation from a simple matter like getting a telephone line installed fast, and favourable treatment at the dentists, to promotion in employment, favourable credits and export licences. Power structures based on patronage are not unique to CPEs and PCPEs.²⁰ Suitable conditions for patronage are a weak political opposition, uncertain political career prospects, and ineffective legal constraints. Under such institutional conditions, patronage can become the main incentive framework of political and economical interaction. Patronage should be distinguished from mere corruption, as the latter is mostly volatile and unpredictable whilst patronage is a stable system of informal rules and regulations. Patronage can be an effective means of governance within an unstable political environment. Considering the wildly distorted incentive

¹⁹ There is extensive literature discussing clientelism. See, for example, Lemarchand and Legg (1972) and Schmidt et al. (1977).

structures in all aspects of life in most PCPEs, patronage is sometimes the only mechanism keeping political and economic systems more or less intact. However, the boundaries between phenomenon and context are not clearly evident. The analysis of patronage shows the sheer magnitude of institutional deficiencies in PCPEs.

The centralised, hierarchical decision-making system of the Soviet Union and other CPEs came to depend upon patronage.²¹ Patronage has outlived the centrally planned systems and successfully incorporated new political and economic forces. For example, administrative bodies that appear to have no further legitimate reasons for their existence, serve to reward political loyalty through "clepto-patrimonial" (Bardhan 1990: 5) income generation. The political leadership in PCPEs relies on patronage to maintain control.

The budget constraint can be an instrument to maintain 'patron-client relationships' between politicians, officials and enterprise managers. It can be softened to reward and hardened as a penalty. Similarly, Kornai regards the origin of the soft budget constraint in the 'paternalistic relationship' between the state and the firms. (Kornai, 1980: 562) Although he acknowledges the existence of such paternalistic relationships in capitalist systems,²² Kornai (1980: 566) considers it more prevalent in centrally planned economies, as there would be a direct relationship between public ownership and paternalism:

The social ownership of the means of production is accompanied by an active role for state power in the economy. [...] The central authorities take responsibility for the economic situation and, at the same time, they want to use every instrument in the armoury which they deem useful.

The "breaking of the paternalistic relationship between the state and the firm" in order to impose hard budget constraints on the micro-economic level is a

²⁰ Olson (1982) describes the effects of clientelism on capitalist economies.

²¹ Willerton (1992) undertook a profound analysis of the role of patronage networks in elite mobility, regime formation and governance in the FSU with special emphasis on Azerbaijan and Lithuania.

²² Kornai (1980: 566) puts it:

The government has to assume responsibility for the economic situation - and its choice is only one between different sets of targets and instruments for economic policy. It is therefore inevitable that sooner or later more or less paternalistic relations develop between the firm and the state.

common aim behind privatisation programmes in previously centrally planned economies.²³ However, the continuance of patronage relationships and related soft budget constraints are not dependent on ownership structure. Private enterprises can exert 'clientelist' pressures to soften their budget constraint. It depends on the commitment and ability of the state to withstand such 'clientelist' pressures. Privatisation may not therefore overcome such patronage relations. Depending on implementation, privatisation can even enhance such relationships. This is the case if insider privatisation reinforces rent seeking behaviour, as it widens information asymmetries between insiders and the state and strengthens the position of insiders.

A consequence of the disintegration of CPEs, the resulting power vacuum, and inherited and transforming patronage networks is the emergence of insider control.²⁴ Aoki (1995: 3) puts it:

The Tendency [towards insider control] is generic, however, in the sense that it is an evolutionary outcome of communist legacies.

Insider control is defined here as *de facto* or *de jure* capture of controlling rights by the managers of SOEs, often in conjunction with bureaucrats of institutions superior to the enterprises and sometimes with workers.²⁵ Many managers stepped into the control vacuum emerging through the disintegration of central power. Backed up by patronage their positions became omnipotent. The degree and scope of insider control varies across PCPEs and different branches of the economies, depending on the state of the industry concerned and a number of institutional conditions, most importantly the commitment and ability of the state to curb such control and its influence sphere. The establishment of appropriate corporate governance systems should be therefore a major concern of the attempts to harden the budget constraints.

²³ See, for example, Estrin (1994), Hinds (1991: 131-134), Kornai (1990: 57-80), Lipton and Sachs (1990a: 15 and 127), Nuti (1991: 169-170), and Perotti (1994).

²⁴ The process of decentralisation of economic decision-power and the emergence of insider control in CPEs has not been recent but has gradually build up over decades. For the problem of insider control in the FSU and in Azerbaijan see section 5.2.3.

²⁵ This definition is in line with Aoki (1995: 3). For a more detailed discussion of insider control, see Aoki (1995: 7-12), Frydman and Rapaczynski (1994: 141-168), Heinrich (1994).

2.1.2.2 Corporate governance

Corporate governance refers to the mechanisms which ensure control over management and all the subordinate layers of decision making in an enterprise.²⁶ It is vital for safeguarding efficiency, particularly against the multiple layers of principal-agent problems present when ownership and management are separated. As such the central task of corporate governance is to moderate blatantly self-seeking behaviour by agents due to imperfect, and especially asymmetric information. Its instruments are incentive schemes, behavioural rules, dispute-resolution processes and effective penalties in case of failure - for all agents in a corporation from top management all the way down to the factory floor (cf. Brabant 1993: 135).²⁷ Within these instruments one can distinguish between internal incentives (i.e. internal structures and arrangements between principal and agents), and external incentives (i.e. given through the financial system, product market competition, labour markets, legal framework, and bankruptcy) (cf. Muir and Saba 1995). The issue of corporate governance is crucial regardless of the ownership form of the firm, whether in market economies or in CPEs and PCPEs. Effective corporate governance should guarantee financial discipline and, hence, hard budget constraints. At the same time, if sound governance systems are in place, enterprises are more likely to attract external funds.

The literature on corporate governance distinguishes between the Anglo-American, the German, and the Japanese models. The Anglo-American model is based on shareholder sovereignty with competitive capital markets. Problems of x-inefficiency -i.e. management slack, incompetence, and moral hazard- are rectified by outside shareholders through efficient capital markets, external take-over

²⁶ For a fuller discussion of problems of corporate governance, see Berle and Means (1932), Fama (1980), Herman (1983), Hopt and Teubner (1985), Horovitz (1980), Kester (1992), Monks and Minow (1995), Muir and Saba (1995: 17-29), Sandrock and Jäger (eds)(1994), Stokman, Ziegler and Scott (1985), Theisen (1987), and Williamson (1963; 1967; 1979; 1981). For a discussion of corporate governance issues in PCPEs, see Akamatsu (1995), Aoki (1995), Belyanova and Rozinsky (1995), Berglöf (1995), Brabant (1993: 133-137), Frydman and Rapaczynski (1994), Litwack (1995), Pohl, Jedrzejczak, and Anderson (1995), Roland (1995), and Wieners (1994).

²⁷ The organisational literature explored numerous mechanisms of control. For a good overview, see Berry, Broadbent and Otley (1995).

threats, and the market for managers.²⁸ In the German and Japanese models banks play a more vital role in corporate governance. In Germany, banks own a significant amount of shares of publicly traded corporations and they exercise voting rights on behalf of individual shareholders. Banks are also on many supervisory boards (Aufsichtsräte). In Japan, banks own 50% of outstanding shares of stock exchange listed companies (Muir and Saba 1995: 87). Banks are also heavily involved in companies as creditors. In Japan, the Ministry of Finance and the Ministry of International Trade and Industry play a very active part in the monitoring of management.²⁹

Existing governance structures in market economies have of course developed over long periods of time. Moreover each of these models requires a slightly different set of institutional conditions. This includes accounting standards to suit a market economy; robust capital markets; a system of corporate law including bankruptcy law and commercial codes; a record of corporate performance against which to measure the present actions of management; and many other institutions. There is fierce debate about the efficiency of their incentive systems, i.e. stock markets, external take-over threats, and manager-employment-markets.³⁰ Considering also their historical and cultural connotations it is questionable how far such existing corporate-governance rules and institutions can be simply transferred to the PCPE context. These existing systems will have to be tested for their suitability for PCPEs and whether their minimum requirements can be established easily in the foreseeable future. For instance, it is unrealistic to opt only for a system which requires appropriately developed capital markets, as these obviously cannot be established rapidly.

In the PCPEs, corporate-governance issues are of particular relevance. Without the power to enforce central commands and with the old administrative system crumbling, SOEs particularly in the FSU, were left in a control vacuum which was filled by insiders. As discussed above, in most PCPEs these insiders

²⁸ The shortcomings of this governance model were already briefly discussed in the context of principal-agent problems in section 1.2.

²⁹ For a compact account of the Anglo-American, German, and Japanese corporate governance models, see Muir and Saba (1995: 61-91).

³⁰ See section 1.2 for a more detailed discussion.

are to varying degrees integrated into patronage networks which consolidate the power of different fractions of the ruling elite. Thus corporate governance problems in most branches in PCPEs exceed the principal-agent problems known in developed market economies. In its most extreme form, insider control has led to wide-ranging 'spontaneous privatisation' also known as 'insider' or 'nomenklatura privatisation'.³¹ The significance of insider control for both corporate governance issues and privatisation in PCPEs has been only very recently recognised by the literature.³² Insider control puts severe constraints on the implementation of any project to re-establish effective mechanism for enterprise control in PCPEs. The main task is to develop suitable corporate governance institutions which are able either to defeat insider control or integrate it constructively in the reform process.

It has been argued, that suitable corporate-governance arrangements are likely to evolve with time, once privatisation has taken place (cf. Frydman et al. 1992: 2). However, given the multiplicity of privatisation methods and the subsequent ownership structure little can be guaranteed. Moreover, if the creation of appropriate mechanisms of enterprise control are left aside with the hope that future owners will solve the problem after privatisation, it might be too late to save whatever can be salvaged from the state enterprises. Given the uncertainty in the light of general political and economical instabilities, expected privatisation and other measures, many insiders are likely to make "tombstone" decisions -

³¹ Spontaneous privatisation can take the following forms: buying out SOEs through a co-operative with its own funds, using SOEs' material and equipment for the production of privately sold goods and services, diverting resources from SOEs to enterprises in mixed ownership, setting up different kinds of holding companies with less accountability to the state, false bankruptcy and subsequent repurchase of 'unprofitable' enterprises, registration of a new SOE with subsequent withdrawal of the state founder, and purchase of state assets at reduced prices (Radygin 1995 30-31). There are many more such industry and country specific illegal or semi-legal strategies. For further references, see introduction to chapter I.

³² On the problem of insider control, see Aoki (1995), Berglöf (1995), Frydman and Rapaczynski (1994: 141-210), Grigoriev (1991), Heinrich (1993 and 1994), and Leitzel (1995: 93)

asset stripping, general short-termism, etc.³³

Hence, prerequisites of corporate control (e.g. accounting practices, company laws) should be established without delay. Even if the divestment process has begun or is expected soon, a sizeable number of SOEs will remain in public hands, whose control is often captured by insiders. These could be enterprises and utilities which are traditionally in the public sector or which are purposely operated under public control for different reasons, e.g. the reluctance and inability of domestic investors to commit their resources to a tedious and uncertain restructuring process. In any case, those enterprises remaining in the public sector will also need new governance mechanisms to be established. These mechanisms have to suit the particular institutional conditions given in the economy and specific organisation.

Three models of corporate governance have been proposed for PCPEs here defined as: (1) the stock market model, which is moulded from the Anglo-American mode of corporate governance and external financing (cf. Pohl, Jedrzejczak, and Anderson 1995: 3-4), (2) the financial intermediary model, which is based on the German and Japanese style of governance, in which control and financing is provided by banks and other financial institutions (cf. Aoki 1995; Berglöf 1995; Wieners 1994: 157f.),³⁴ and (3) the employee model, in which managers and workers take over formal control (Weitzman 1993).

There are very few proponents of a sole market approach - as the first model suggests. The stock market model is also widely regarded as ineffective in dealing with the problem of insider control (Aoki 1995: 3-4). Banks are regarded at least theoretically as able to play an effective monitoring role in the corporate governance structure of viable insider dominated firms, both on an arm's length and a control-oriented basis (cf. Aoki 1995; Berglöf 1995; Perotti 1994; Roland

³³ There has been hardly any empirical research conducted on the issue of asset stripping. Predictions can therefore only rely on anecdotal evidence. However, there is quite a compelling logic behind the assumption that the degree of asset stripping is a function of the prevailing political and economic uncertainty.

³⁴ One can distinguish between control oriented and arms length financial control systems (Pohl, Jedrzejczak, and Anderson 1995: 7). However, as argued in Berglöf (1995), these systems can be seen as complementary. A good discussion of different models of bank control is given by Wieners 1994: 157f.)

1995). However, as already stated above, an effective banking system and its complementary institutions will still have to be developed. The third model accommodates fully for prevailing insider control. In practice often an eclectic approach towards corporate governance is suggested, supporting a simultaneous development of different systems (cf. Aoki 1995; Pohl, Jedrzejczak, and Anderson 1995: 7).

A first step proposed by the first two models is corporatisation and commercialisation, including their legal foundation and prerequisites such as the introduction of new accounting and auditing standards and changes in the structure of organisation. Corporatisation is mostly defined as enterprise reform that alters the legal position of a business activity into a joint-stock company or similar legal entity according to relevant statutes and decrees. Simultaneously the development of the financial system and its complementary institutions are proposed.

First experiences with the corporatisation process have shown that it cannot be simply introduced off-the-shelf. It is not enough to fulfil formal requirements of the corporatisation legislation, such as holding shareholder meetings and establishing a board of directors, if these are only pro forma and, therefore, meaningless. Moreover, preconditions have to be developed in the enterprise itself which create transparency, accountability, and the rule of law.

To summarise: effective corporate governance is both important for financial discipline and the ability to attract funds. There are various internal and external incentive and discipline mechanisms necessary to enforce corporate control. Many, e.g. a sound banking system, have still to be developed in PCPEs. The concentration on ownership per se fails to address attention to the complexity of institutional arrangements which constitute corporate governance particularly in the context of insider control. Privatisation can be only seen as a tool to assist the establishment of enterprise control. However, the initiation of appropriate corporate governance structures depends on many other institutional conditions, one of them the commitment and ability of the state to provide and maintain the legal foundations, e.g. a system of corporate law including bankruptcy law and commercial codes. Without these legal prerequisites it will be difficult to establish

corporate governance structures regardless of whether privatisation takes place or not.

2.2 Dynamic efficiency: structural change

Dynamic efficiency is here defined as the ability to adapt to a changing environment and hence maintaining a long-term efficient allocation of scarce resources. This involves, particularly in the context of PCPEs, intra-enterprise restructuring, as well as inter-sectoral reallocation of scarce resources. A precondition of industrial restructuring in PCPEs is the establishment of effective corporate governance, which attracts the external sources of finance and expertise necessary for the purpose of restructuring. The initiation of industrial restructuring is also crucially dependent on whether the state can withstand clientelist interest to impede changes, as discussed below. Thus, these vital issues are inseparably intertwined, and the discussion of patronage networks and corporate governance is also of significance for restructuring. The question addressed is whether dynamic efficiency and hence successful industrial restructuring is dependent on an enterprise being public or private.

The industrial sector of most PCPEs is characterised through excess capacity, low profitability, environmental pollution, and increasing technological obsolescence.³⁵ In the FSU highly vertically integrated industries of gigantic plants makes production in the individual republic dependent on deliveries from other republics (cf. Leijonhufvud 1993). Due to the political basis of production location decisions, uneconomic transport costs arose; the transaction costs remain, but the political necessity has perished. The restructuring requirements are therefore exacerbated in the newly independent republics of the FSU. In all PCPEs relative prices have changed due to price liberalisation and the termination of producer and consumer subsidies. There has also been increasing adjustments of prices for resources and raw materials to world market prices. Consumer patterns have drastically changed due to import liberalisation. And because of the

increased foreign competition, upgrading and modernisation of technology has become unavoidable in many sectors. There has been a sharp decline in real investments, in some PCPEs for almost the last eight years. The outdated dominance of the military-industrial-complex requires fundamental conversion. And this list could be endlessly continued and detailed. Generally, all PCPEs face crucial restructuring problems which vary according to country and sector. These are possibly more important empirical starting points than any analytical or ideological predispositions towards public and private enterprise.

Intra-enterprise restructuring requires physical capital changes (e.g. streamlining, downsizing, recapitalisation), technology and organisation changes, management changes, human resource development, changes in infrastructure components, financial restructuring, and changes in products and markets. A very important issue in the context of PCPEs is demonopolisation. Inter-sectoral restructuring involves identification and development of promising sub-sectors, SME-development, and new enterprise promotion. And of course, restructuring requires skilled and experienced implementers and extensive financial resources.³⁶ Major state involvement will be unavoidable in PCPEs, given the extent of the restructuring required, the massive capital needs without capital markets capable of providing them, dearth of foreign investment, and the high costs of expected externalities.

Whilst industrial restructuring on an aggregate level might stimulate growth and ensure efficient allocation of scarce resources, it can often have a long-term negative impact on wealth and income on insiders of the industries concerned. Streamlining and downsizing inevitably will lead to diminished asset

³⁵ For a detailed analysis of the state of the industries in the PCPEs, see EBRD (1995), ECE (1995), Hare (1996), Hesp (1994), Hughes and Hare (1992 and 1994), Newbery and Kattuman (1992), and Richet (1993).

value, change in management and employment, the extent of which is dependent on the asset specificity of the individual plant. Often, the most prestigious giant enterprises are the ones most concerned. The potential threat to powerful vested interest groups creates massive resistance to such changes. These powerful conservative forces can use the solidity of their above mentioned patronage networks to delay or defeat restructuring. The crucial factor is political power rather than formal ownership rights. The underlying strength of conservative interest groups, no matter whether in private and public enterprises, should not be underestimated. Experiences in capitalist economies where supposedly private companies were bailed out by state intervention reconfirm this argument.³⁷ As mentioned above, depending on the implementation of privatisation, rent-seeking behaviour could be even intensified.

The privatisation of monopolies might not even be desirable predemonopolisation (cf. Carlin and Mayer 1992). The effectiveness of newly introduced anti-trust policies is highly questionable. The latter are mostly based on a market economy context, but the complementary institutions are mostly missing.

As in the whole privatisation debate, it is difficult to evaluate the usefulness of privatisation for the initiation of industrial restructuring without considering country, sector, and enterprise specific factors. The discussion over privatisation of large enterprises which require a great deal of restructuring is often highly hypothetical, as potential buyers who have also the capital for restructuring at their disposal, are hardly forthcoming.

³⁶ There is extensive theoretical and empirical literature on industrial restructuring. For a good summary of the issues involved, see Atiyas, Dutz, and Frischtak (1992), Bagchi (1987), Lieberman (1990), Roe (1984), and Thomas, Romijn and Uribe-Echevarria (1991). For recent studies of the PCPE context, see Atiyas (1994), Begg and Portes (1992; 1993), Blasi, Panina and Grachova (1995), Borish, Long, and Noel (1995), Carlin and Mayer (1992), Estrin and Richet (1993), Filatotchev, Buck and Wright (1993), Hare (1996), Hillman and Milanovic (1992), Hughes and Hare (1992a; 1992b; 1994), Kharas (1991), Mann (1991), Newbery (1990), Richet (1993), Roland (1993), Schutte (1993) Sood (1991), Traxler and Unger (1994), UNIDO (1993) and Wilson (1995).

³⁷ Rowthorn and Chang (1993: 62) mention the Chrysler rescue operation in the USA and the nationalisation of the shipbuilding industry in Sweden.

2.3 Origins of property institutions and institutional change

Traditional economic theory neglects the process in which property rights are formed and altered. Property rights are treated as exogenous and clearly defined. However, such a view is of little use, if the effects and the process of changes in property rights are examined, i.e. how the changes can be achieved and whether the actual changes are efficient solutions to issues of corporate governance and industrial restructuring.

Property rights are defined for the following as social institutions that delineate the boundaries of rights on specific assets. There is a bundle of rights attached to each asset, e.g. the right to transfer the asset.³⁸ Libecap (1993: 1) describes the range of institutions which constitute property rights as following:

Property rights institutions range from formal arrangements, including constitutional provisions, statutes, and judicial rulings, to informal conventions and customs regarding the allocations and use of property. Such institutions critically affect economic behavior and performance. By allocating decision-making authority, they also determine who are the economic actors in a system and define the distribution of wealth in a society.

In the debate about privatisation in PCPEs de facto property rights given through informal conventions and customs, are generally ignored.³⁹ This is reflected in the top-down design of most privatisation programmes, which authorise a central authority with the task of privatisation. The underlying assumption is that the state holds the control rights of its enterprises. However, in reality, insiders have taken over the control of a significant amount of enterprises in many PCPEs, and they are unlikely to relinquish them silently.⁴⁰ Generally, sanitised textbook economics neglects the implications of distributional struggles attached to proposals for institutional change. These struggles are less fierce in western economies as many institutions are not seriously questioned. To understand the implications of institutional change fully for PCPEs, one has to

³⁸ See also section 1.2.

³⁹ Exceptions are Heinrich (1993: 12f) who argues that privatisation could be only politically accomplished if these de facto property rights were also recognised de jure. This position also is taken by Leitzel (1995: 93).

imagine the reactions of the western industrial elite if it were seriously threatened with loss of its economic and political power.

So far, the existing rights structure in PCPEs has led to massive economic decline, combined with capital destruction and capital flight. The changes in relative prices have not led to industrial restructuring and viable corporate governance structures and rescue efforts for many industries will be too late. Why can the existing property rights structure not easily be replaced with one which is more conducive to economic recovery as some proponents of the New Institutional Economics suggest would happen? The answer lies with the bargaining parties involved, the range of institutional options the latter are facing, and the complexity of factors influencing the calculation of private expected net gains from alternative institutional forms. Libecap (1993: 3) puts it:

As with earlier examinations of property rights, the institutional analysis literature tends to be the more optimistic one, viewing the design of various governance structures as maximizing decisions to economize on transactions costs. A problem with such claims, however, is the general failure to specify the size of the net benefits achieved from the adoption of a particular institutional form relative to the returns offered by its alternatives. This failure to identify the range of institutional options confronting decision makers and the likely costs and benefits associated with each one, makes it difficult to evaluate the maximization claims.

Property rights in any economy are the key to the distribution of wealth and political power. Any proposed institutional change will lead to complex 'contracting'. Contracting is the term used by the literature on institutional change for the whole process of bargaining over the assignment of new property rights and the modification and elimination of existing property rights (cf. Libecap 1993: 4). Contracting is carried out on two levels:

1. the intra-group level, on which rules and customs regarding the allocation from and control over property rights - hence the status of members - are re-bargained, e.g. the reshuffling within patronage networks; and

⁴⁰ On the emergence of insider control see section 2.1.2, and see section 5.3 for a discussion of insider control in Azerbaijan.

2. the inter-group level, on which institutional changes are disputed between the different groups. The latter includes also lobbying, political negotiations and adjustments of the legal framework (cf. Libecap 1993: 4).

Each of the contracting parties and their individual members tries to maximise or minimise his/her gains or losses, respectively. However, their agreement on institutional change depends on factors influencing their expected net gains, as the latter cannot be fully anticipated.

The outcome of the institutional change is mainly dependent on two aspects. The first aspect is whether expected losers can either be defeated outright or persuaded into agreement through some kind of compensation. For example, a minister, whose power and income stream (possibly from informal arrangements) could be threatened by institutional changes could be persuaded to agree through offering another ministry or chair of a committee. Second, and most important, the outcome depends on whether important groups expect a private gain out of the institutional change.

The contracting process can block institutional change or alter the original proposal quite significantly. Thus the ultimate property rights arrangements often bear little resemblance with the initial proposal (cf. Libecap 1993: 6). The literature on privatisation in PCPEs has widely disregarded this implication of the contracting process and thus overoptimistic with its expectations from privatisation. Libecap (1993) points out that historically institutional changes, which would have led to aggregate economic gains were often blocked as influential interest groups feared their political and economic base would be undermined.⁴¹

Contracting for property rights is an extremely complex process. It is hardly possible to calculate the net gains of all institutional options for every single contracting party. However, the analysis of the contracting process can be assisted by the identification of the contracting parties and the general factors which

⁴¹ Libecap's analysis is also confirmed by several historical studies. For example, the studies of Scheiber (1973), Hughes (1977) and Friedman (1985) on the role of interest groups in influencing property law and government regulation in nineteenth-century America come to this conclusion. Olson's (1982) study on the economic development of western economies in the post-World War II period supports this view.

influence an agreement to the adjustment of the property rights structure. Again, this is not possible without considering country, sector, and enterprise specific factors.

2.4 Conflicting and inconsistent goals

Besides the economic motive of enhancing efficiency, there are other rationales behind privatisation in PCPEs.⁴² Although the aspect of efficiency remains the main focus of this work, possible conflicts and inconsistencies with other motives and goals will be shortly evaluated in the following to complete the picture. There are various additional rationales behind privatisation, five of which are particularly relevant to the context of PCPEs.

First, one motive for privatisation is to create a capitalist class with attitudes, behaviour and motives of economic agents in a market environment. In this context, the 'strengthening of the share-holding culture' is often stressed (cf. Brabant 1992: 156; Dallago 1995: 242-245). However, this 'popular capitalism' is an unlikely outcome of privatisation in most PCPEs due to the historical and institutional conditions in these economies. Besides, the 'share-holder society' is even a myth in most developed market economies with share-holders constituting only 21% of the entire population in Anglo-Saxon countries, 16% in France and a mere 5% in Germany (Liener 1993: 26).

Second, another motive for privatisation is to attract foreign investments. International and supranational organisations (e.g. IMF and IBRD) often make their assistance dependent on progress in the privatisation process. In most PCPEs the inflow of foreign capital so far has been small or negligible.⁴³ This is not astonishing, given the wide range of global investment opportunities and the high risk due to political and economic instability in most PCPEs.

⁴² On motives and goals of privatisation in PCPEs, see Bornstein (1992: 284-285), Brabant (1992: 156-160), Dallago (1995: 242-251), Dhanji and Milanovic (1991: 13-18), Lavigne (1995: 158-159), and Kilmister (1995: 90-92).

⁴³ There are partial exceptions such as Hungary, the Czech Republic, and Poland (Lavigne 1995: 163). However, Lavigne (1995: 164) doubts whether foreign capital in any PCPE exceeds 10-15% of total capital endowment.

Third, privatisation is to assist macroeconomic stability, by reducing the 'monetary overhang' whenever savings are large and by providing fiscal revenue through the termination of subsidies, disposal of loss-making activities and directly by sales revenues. However, assuming that the sales price equals the present value of the foregone net income, the state budget should remain unaffected (Mansoor 1988). In most PCPEs the monetary overhang has been wiped out and the propensity to save diminished by inflation. And experience has shown that privatisation revenues are insufficient. For example, the German Treuhand accumulated DM 270 billion in debts with sale receipts only amounting to DM 53 billion (Lavigne 1995: 158).

Fourth, the distribution of society's wealth on an equitable basis is often emphasised as a goal of privatisation in PCPEs (cf. Bornstein 1992: 285; Brabant 1992: 159-160; Perotti 1994: 56; Wieners 1994: 81). Considering the contributions made to capital accumulation by the whole society, this might be a legitimate plea since equity equability is often discussed as a rationale behind free transfer methods.⁴⁴ However, the realisation of an equitable distribution is very unrealistic. Due to imperfect and asymmetric information, insiders will always have an advantage especially if passive minority share-holders are involved. After all, those who control the assets, and hence have the discretionary right to decide on their use, are the main beneficiaries. This is particularly the case in PCPEs with their fragmentary institutional frameworks. A sceptical view of such an equitable privatisation is best represented by Weitzman (1993: 252):

Capitalism is not a fair system and capitalists are not nice guys, at least not at their business dealings. Whether inadvertently or as part of a promotion strategy, this central fact has been massively camouflaged behind all the sanitized talk about transition to a "market system" [...]

No matter how it is accomplished, there is no way that privatisation is not going to end up with some unpleasant characters becoming relatively rich and some virtuous innocents losing out. This is what capitalism is all about. Under capitalism, society does not attempt to micromanage individual incomes, because to do that kills the goose that lays the golden eggs.

Under capitalism there is a lot of randomness, resulting in many undeserving winners and unjust losers. The winners in the new systems of Eastern Europe are likely to be correlated with the winners in the old

⁴⁴ For a detailed discussion of free transfer methods, see section 3.1 and 3.3.

systems of Eastern Europe, because there is a statistically significant, if not perfect, correlation between aggressive opportunists in both cases, and in the end there is not a whole lot that can be done about it.

The democratic gesture of equity is often merely a strategy to sell broad privatisation (cf. Perotti 1994: 57; Vickers and Yarrow 1988: 121).

Fifth, there is the ideological motive that privatisation should induce a rapid systemic change by dismantling the whole centrally planned production system and thus ensure that the process of overall change is irreversible (cf. Brabant 1992:158; Major 1993:53).

Inconsistencies and conflicts between different motives and goals are likely to arise in any privatisation. Priorities have to be set from case to case. However, in the context of PCPEs conflicts between different objectives could be particularly grave due to the deficiencies in institutional frameworks. First, there exists a variety of contradictions between the establishment of a stable capital class and other motives. The most obvious domestic candidates to form this class are insiders and their appendages as they hold vital insider information and are most experienced with the industrial infrastructure. Moreover, due to the sluggish control in recent years, most of them were able to accumulate capital illegally through spontaneous privatisation.⁴⁵ As discussed above, it will hardly be possible to neglect the deeply entrenched interests, rights and privileges of these forces. However, there is the danger of perpetuation of patronage relationships between the state bureaucracy and these former nomenklatura members who become new capitalists and retain soft budget constraints. Enterprises with light restructuring obligations and a foreseeable recovery might embark on restructuring. Others might rather rely on rent-seeking activities rather than initiate serious restructuring.

Second, the emphasis on broad share-ownership is likely to undermine sound enterprise control and hence efficiency.⁴⁶ Dispersed ownership will entail

⁴⁵ The issue of spontaneous privatisation was discussed in section 2.1.2. For the consideration of insiders in the privatisation process, see also chapter 3.

⁴⁶ The issues of free transfer of shares and sales through capital market operations and public offering are discussed in detail in chapter 3.

insurmountable principal-agent problems in the absence of capital markets, as discussed above.

Third, there are conflicts between attracting foreign capital and other motives. Foreign investors are more likely to buy enterprises with the least need for restructuring, monopoly enterprises, or invest in green-field projects (cf. Lavigne 1995: 164). There is much anecdotal evidence about foreign investors buying up potential domestic competitors just to close them down. Thus restructuring problems will not necessarily be solved. Attempts to de-monopolise could be undermined. Moreover, foreign capital is often only attracted through offering wide protective measurements (e.g. tariff or tax concessions) which would collide with fiscal objectives (Lavigne 1995; 164). Privatisation programmes sped up in order to satisfy funding conditions of international and supranational organisations might not comply with the motives of restructuring and the establishing sound enterprise control.

Fourth, the goal of high privatisation receipts might in theory withdraw resources from restructuring depending what these receipts are used for. However, this has hardly arisen.

Fifth, the ideological motive of making the overall change irreversible provokes the attitude of privatisation for privatisation's sake irrespective of its consequences for restructuring and corporate governance. The attitude of making overall privatisation as the touchstone of economic and political development regardless of sectors, branches and enterprises diverts the discussions and efforts from tackling the imminent restructuring needs. Purely ideological decision-making could end up by squandering valuable resources.

Other examples of contradictions are multiple. The essential point is that most PCPEs, which experience massive economic decline, require fundamental restructuring in most sectors and lack an institutional framework of a market economy. The different objectives of privatisation can conflict quite sharply. The designers of privatisation strategies have to set their priorities and allow trade-offs to be made. Ideally this should be at a sector or even a branch or enterprise level.

Concluding remarks

This chapter analyses the relevance of the ownership structure for enterprise efficiency out of the perspective of political economy. Looking at static efficiency a variety of institutional conditions were examined which are responsible for soft budget constraints. It was concluded that the existence of these institutional conditions and hence soft budget constraints are due to (a) a system of political control based on patronage; and (b) the lack of appropriate corporate governance systems. The analysis showed that the exact manner in which soft budget constraints arise is extremely complex, reflecting power struggles between various political and economical interest groups. Formal ownership per se is hardly central for the enhancing of static efficiency. The increase of dynamic efficiency and hence industrial restructuring in the context of PCPEs is dependent on the strength of conservative forces to resist change regardless of whether in private or public enterprises.

Depending on the implementation, privatisation can be a tool to overcome patronage relationships, to help to build up appropriate enterprise control mechanisms, and, finally, to initiate industrial restructuring. Various methods of privatisation have to be examined for their suitability. Moreover, country, sector, and enterprise specific factors comprising the institutional framework have to be taken into account. Here it is important to stress that the common tendency to regard the PCPE as uniform and force them conveniently under the heading of 'Eastern European' does not take sufficiently into account the vast differences across countries and enterprises. The economies differ profoundly in their industrial structure and overall development, the degree of macroeconomic stability, the extent of microeconomic decentralisation, their exposure to international trade, and their political stability. Hence generalisations based on research from one country cannot be simply extended to others.

A major shortcoming of most of the literature on privatisation in PCPEs is to ignore the very definition of property rights and their formation. A privatisation proposal cannot be viewed in a vacuum, it has to be understood as proposed institutional change which leads to a complex process of contracting for property rights. The outcome of the latter is central to whether proposed privatisation can

lead to enhanced efficiency. In this context it is particularly relevant to consider de facto property rights of insiders prevailing to different degrees in the economies concerned. Insider control is a major problem in most PCPEs. Of paramount importance here is the power of the state. Is the state willing and able to implement a reform programme conducive to enhanced static and dynamic efficiency, or is it weak, susceptible to counterproductive rent-seeking activities of insiders?

3. Methods of privatisation

Introduction

In previous chapters, it has been shown that the justification for privatisation on purely economic grounds is very limited. This is the case when ownership and control rights are separate, especially in the context of PCPEs. The discussion of institutional conditions responsible for insufficient static and dynamic efficiency concluded that the emphasis on ownership structure per se is inadequate. It was suggested that in the context of CPES and PCPEs the system of political control based on patronage and the lack of appropriate corporate governance generates soft budget constraints and enables conservative forces to delay and defeat effective industrial restructuring. In this context privatisation can be regarded as one means of squeezing out old patronage networks and marginalising conservative forces, of building up an adequate system of enterprise control, and hence, hardening the budget constraints and opening up the way for restructuring. For privatisation to be successful in this way, the economic, political and, above all, institutional pre-conditions are of great significance. Moreover, there are a number of important issues to consider. These are the questions of to what extent insiders have captured control rights over the SOEs which are to be privatised; information and valuation problems; and the lack of experience and expertise of privatisation administrators.

The aim of this chapter is to evaluate methods of privatisation which have been proposed for PCPEs and which have, to varying degrees, been implemented. The question is whether the outcomes of the various methods lead to more or less static and dynamic efficiency. The other aspect looked at is the transaction costs of privatisation. In the literature on privatisation, transaction costs are widely neglected (cf. Blanchard et al. 1991; Estrin 1994; Kornai 1992; Lipton and Sachs 1990b; Richet 1993). On the contrary, here, the following hypotheses are

proposed: (a) privatisation is causing significant transaction costs,¹ which vary according to the method of privatisation; (b) according to the method of implementation privatisation has more or less impact on static and dynamic efficiency. The assumptions made are bounded rationality and opportunism of the economic agents, imperfect and asymmetric information, and asset specificity (cf. Simon 1982; Williamson 1985).² Moreover, it is assumed that it is a strong policy maker who is only following the goal of hardening the budget constraints and initiating industrial restructuring in his/her privatisation efforts. With the last assumption the problem of conflicting and inconsistent goals as discussed above will be avoided.³

The first section begins by providing an analytical framework in which the various methods of privatisation are categorised and analysed. The second section is concerned with valuation methods which are considered as vital for a successful privatisation process. The following three sections are concerned with the various methods of privatisation which are divided into the groups 'free transfer', 'sale', and 'divestment of user rights'.

3.1 An analytical framework

Transaction costs and the question of which method of privatisation will be most conducive to efficiency in the enterprises are interrelated. Transaction costs are defined as costs incurred for the purpose of defining and redefining property

¹ Brücker (1993: 49) also grounded his analysis of privatisation methods on this hypothesis, but without the same emphasis on static and dynamic efficiency. In his analysis he considered the same factors, i.e. (1) allocation-criterion, (2) Contract-type, (3) Economic competence, (4) Potential capital contributions, (5) initial distribution costs, (6) agency costs, and (6) realignment costs.

² Brücker (1993) based his approach on the assumptions of bounded rationality and opportunism of the economic agents, and asset specificity.

³ See chapter 2.4.

rights.⁴ These include costs of (1) information gathering and its processing; (2) bargaining and monitoring the assignment of property rights including the definition of their boundaries; and (3) enforcing the underlying contracts. The purpose of privatisation is to enhance efficiency. As stated above, the main conditions for static and dynamic efficiency in PCPEs are the break up of patronage networks, the adoption of an adequate corporate governance system and industrial restructuring. In this context transaction costs comprise defining and redefining property rights effectively. The costs of redefining property rights can be also regarded as 'realignment-costs' (cf. Demsetz 1966: 65), i.e. costs involved in correcting the initial assignment of rights.⁵ The level of costs determines whether privatisation is successful. When the costs of a particular method are high it is unlikely that privatisation will be accomplished as proposed.

Particularly in the context of privatisation in the PCPEs it is thought appropriate to assume (1) imperfect and asymmetric information (2) bounded rationality; (3) opportunism and (4) asset specificity (cf. Brücker 1993: 49-52). Concerning the first assumption, insiders and particularly the old management will have an information advantage about the status quo of the enterprises. The problem of imperfect and asymmetric information increases with size and degree

⁴ The concept of transaction costs has no agreed definition in the literature. For example, Coase (1937) and Demsetz (1968: 35) emphasise in their definition the costs of using markets. Dahlmann (1979: 248), and Picot and Dietl (1990: 178) focus on control and information costs. Vuylsteke (1988:139) highlights, in the context of privatisation, transaction costs as administrative costs, financial restructuring, physical rehabilitation and settlement of employment claims. He distinguishes between transaction costs and residual costs. Here, Matthews (1986: 906) will be stressed, who defines transaction costs as:

[...] costs of arranging a contract ex ante and monitoring and enforcing it ex post, as opposed to production costs, which are the costs of executing the contract.

⁵ Brücker (1993:52) points out the significance of 'realignment costs' as part of the overall transaction costs of privatisation.

of asset specificity of enterprises. Accordingly information about the implementation of privatisation will be asymmetrical. Concerning the second assumption, one can anticipate difficulties in collecting, processing, and disseminating information concerning the enterprises to be privatised, the potential buyers and beneficiaries, and the implementation of privatisation. The third assumption refers to self-seeking agents who could also employ non-co-operative behaviour, such as breach of contracts and outright dishonesty. This is an assumption which is particularly pertinent in PCPEs given their weak institutional frameworks. The fourth assumption implies that physical and human assets are bound to specific transactions and will lose value if they are redeployed.⁶ As enterprises are heterogeneous goods, their workers and managers require specific knowledge and competence. With increasing asset specificity and size of enterprises, these requirements also intensify. In case of separation of ownership and control, rising demand in specific knowledge and competence of managers will also lead to increasing agency costs (cf. Brückner 1993: 51).

The following evaluation of privatisation methods can only offer qualitative insights into the level of transaction costs. For a more comprehensive analysis it would be necessary to consider far more firm-specific information, concerning the administrative bodies implementing privatisation and who are the potential buyers and beneficiaries. Obviously, this lies outside the scope of this chapter. However, the following should be noted. First, there are factors discussed in the next section under the heading 'valuation', these are (1) firm size, (2) asset specificity, (3) branch details, (4) 'political value' (Frydman and Rapaczynski 1994: 191), and (5) other firm details. Second, the conditions within the administrative bodies regulating privatisation are above all competence of, and

⁶ As stated further above, the notion of asset specificity is particularly relevant to industrial restructuring which has a negative impact on income and wealth in the short-run. This is the reason why owners are resistant to change. A change of ownership does not guarantee a willingness to change more generally.

authority given to, the administrators, and the question of how far they have effective control over the objects to be privatised. Third, the economic competence of potential buyers and beneficiaries is of importance. This includes ex post the ownership and control structure in case of a closely held firm, and whether in case of a joint stock company it is open or closed (cf. Bim, Jones, and Weisskopf 1994: 253-255). Moreover, their financial situation is significant, i.e. how far they can contribute capital. These last two aspects can only be roughly addressed in the following broad analysis.

The factors considered in evaluating the transaction costs of various privatisation methods are listed in Table 3-1.

Table 3-1: Evaluation criteria

1.	Sale vs. give away
2.	Distribution criteria
3.	Administrative costs
4.	Realignment costs
5.	Contract-type
6.	Economic competence
7.	Potential capital contributions
8.	Insider-control
9.	Agency costs

(1) *Sale vs. give away*

The question whether enterprises should be privatised via sale or 'give away' has been hotly debated in the recent literature, with almost general consensus in favour of free transfer methods (cf. Wieners 1994: 67-92). In fact, the discussion of this question reflects the present quality of the whole privatisation debate. For the majority of contributors, the ownership question per se is central. Therefore they favour any means to speed up the privatisation process regardless of its outcome. Privatisation itself seems to have become the surrogate goal of these efforts. The effects of a particular privatisation method on enterprise control mechanisms, patronage networks and restructuring efforts are hardly considered. Practical issues concerning the implementation of privatisation, e.g. valuation and availability of savings, outweigh these more long term considerations. Some have recognised the deficiencies of the debate. But the focus is only slowly shifting in the on-going discussion from rather practical considerations to the effects of

privatisation on corporate governance and industrial restructuring (cf. Estrin 1994: 6).

The arguments in favour of free transfer methods are of a practical nature and often subsumed under 'obstacles to privatisation' (cf. Brabant 1992: 175-201). First, most arguments are in line with the so-called 'critical mass' theory (Grosfeld and Hare 1991: 131; Roland and Verdier 1992). In the latter it is argued that the share of the private sector in an economy would have to reach a 'critical mass' before dynamic and informational advantages of a market economy could arise. Therefore a speedy privatisation is supported. However the analysis overemphasises the ownership structure and neglects the question of whether a formal privatisation can engender desired *de facto* improvements in static and dynamic efficiency.⁷

Second, one strand of argument is concerned with scarce domestic savings (cf. Wiener 1994: 67-71).⁸ Again the question arises whether a privatisation for ideological reasons will lead to the intended effects on governance structure, industrial restructuring and above all overcome entrenched patronage networks. This is crucial if the result of privatisation is a large number of minority share holders, a problem which still has to be discussed. Will these minority share holders 'convey effective property interests', particularly if the shares are not 'considered genuinely valuable and cannot themselves be traded', due to undeveloped or non-existent secondary capital markets (Frydman and Rapaczynski 1994: 186)? And moreover, what implications will scarce domestic savings have for the massive capital requirements for restructuring? A popular

⁷ Roland and Verdier (1992:9) recognise the problem of abuse in corporate control. In order to reduce it, they suggest that 51 per cent of all shares of an enterprise could be held by a core investor and the rest of the shares, at most 49 per cent, could be distributed to the population. Implicitly they assume that the majority of these core investors would come from abroad, which is highly unlikely for most of the enterprises, especially in countries like Azerbaijan, as discussed elsewhere in this thesis.

⁸ The problem of scarce domestic savings is widely discussed, especially in the early literature on privatisation in PCPEs (cf. Estrin 1994: 5). See, for example, Blanchard et al. (1991: 36f.), Blanchard and Layard (1990: 17), Bös (1990: 190), Borensztein and Kumar (1991: 304), Brabant (1992: 187-188), Gruszecki and Winiecki (1991: 81f.), Kirchner (1992: 13), Milanovic (1991: 28), Kluson (1991: 11), and Lewandowski and Szomburg (1989: 264). See also chapter 3.4 in this volume.

proverb says 'one does not look a gift horse in the mouth'. Here however, it is implicitly expected that masses of ready made minority share holders are hurrying out to buy their gift horse a set of gold teeth with their last few pennies.

Third, it is argued that free transfers would circumvent valuation problems (cf. Bim et al. 1994: 256-257; Wieners 1994: 71). The complex issue of valuation is discussed below. Valuation including inventory assessment is essential for industrial restructuring and crime prevention both before and after privatisation. Avoidance of valuation is short-sighted as it loses information necessary for industrial restructuring and hence industrial policy. Thus it jeopardises the success of privatisation, not to mention the political discontent it would cause in the population. Frydman and Rapaczynski (1994: 16) express it as follows:

It might be possible, of course, for the state to convey the title of a company to some private party without engaging in an assessment of its value, but such a naked transfer, quite apart from the legitimacy problems that might arise, would not, by itself, accomplish anything of economic significance. The purpose of privatisation [...] is not to transfer title, but to initiate a restructuring of enterprises and a rationalisation [...] In order for this to take place, someone must evaluate the potential of each enterprise to be privatised [...] Only in this way is it possible to decide where best to invest the limited resources available for the upgrading of the economy.

Fourth, free transfer methods to the population are favoured for equity considerations (cf. Perotti 1994: 56; Wieners 1994: 81). The question of equitable division of benefits, especially if passive minority owners are involved, has already been discussed above.⁹ However, in the following analysis this aspect of equity is not considered.¹⁰

Wieners (1994: 82-91) detects three strands of arguments against a 'give away'. First, possible inflationary effects are discussed. These result from wealth effects on consumption: recipients of shares in companies are thought to consume more, as they feel themselves richer. However, given both the low propensity to save and the immense uncertainty in the countries concerned, such a wealth effect

⁹ See section 2.4.

¹⁰ The democratic gesture of equity in proposed mass privatisation programmes reveals its hidden rationale when the marketing effects of this 'popular capitalism' are emphasised: one can better sell privatisation to the broad public, if one gives them the impression that they could participate (cf. Perotti 1994: 57, Vickers and Yarrow 1988: 121).

is highly unlikely (cf. Wieners 1994: 83). The other inflationary effect is seen through free distributed vouchers being used as a money substitute. A detailed presentation of this argument is beyond the scope of this chapter. However one can note Wieners (1994: 88) two counter-arguments: (1) even if vouchers stimulate an inflationary effect, they are not the origin of inflation and (2) there are possibilities to limit the fungibility of vouchers.

Second, it is claimed, that free transfer would jeopardise an increase in fiscal revenue. The viability of the revenue-generation as motive for privatisation was already discussed above.¹¹ Again this aspect is not reconsidered in the following.

The third argument is more significant for the following analysis. It claims that a free distribution of shares would not initiate the necessary incentive structure for private property. Holders of gift-shares would not feel themselves so inclined to monitor managers of their enterprises so effectively as those who would have bought their own shares (cf. Wieners 1994: 90-91). It is impossible either to confirm or to reject this argument on the basis of abstract behavioural theory. Nor is it possible in the scope of this chapter to do so without an interdisciplinary case-by-case approach, involving disciplines such as psychology and ethics. The argument is related to that of the superiority of private ownership because of its underlying incentive system, which was discussed in chapter 1. There, and in the context of corporate governance, matters of 'shareholder collective action' and the 'voice option' and minority investors were raised. Considering these problems, monitoring is always difficult, whenever control and ownership are separate and the latter dispersed. Principal-agent problems will be particularly fierce in the environment of most PCPEs without the necessary legal framework and law enforcement and other essential institutional preconditions. However, one can assume that holders of gift-shares have less authority over entrenched interest groups, especially if ownership is widely dispersed. This is dependent on various other factors as discussed below.

¹¹ See section 2.4.

Whether the choice between sale and give away methods is relevant for the intended outcome of privatisation cannot be answered in the abstract. There are a variety of different free transfer and sale methods. Depending on the distribution criteria, including possible conditionality and various other factors, a give away method can be superior or vice-versa. However, in conjunction with the other factors, it is assumed in the following analysis, that free transfer methods are indicative of weaker corporate governance and/or a resistance towards change.

(2) Distribution criteria

Various criteria can be employed to determine new ownership. In case of sale, the simplest criterion is the price that a potential new owner is prepared to pay. Multiple distribution criteria are rejected by neo-classical disciples. In their world of perfect competition and its underlying assumptions, the distribution is done most efficiently by the price mechanism. The interference of a state agency and the introduction of additional distribution criteria could only lead to the 'risk of bureaucratic corruption and regulatory capture' (Maskin 1992: 118). Given the weak institutional framework in most PCPEs these risks are always prevalent and have to be taken into account. However, the price will not convey a variety of information under the assumptions of imperfect and asymmetric information, bounded rationality, opportunism, and asset specificity. Indispensable criteria are for instance the viability of restructuring and business plans, including financial plans. Potential capital contributions need to be examined. If insiders are directly considered as buyers or beneficiaries, their previous performance should be scrutinised. Without such considerations it is impossible to decide the buyer or beneficiary with the best capability. The more complex the criteria the better one can influence the possible outcome of privatisation.

The chosen distribution criteria are among the most important factors which influence the outcome of the privatisation. They should be central to the

debate. It is astonishing that there is no discussion over distribution criteria in the literature.¹²

It is clear, that privatisation in the PCPEs is carried out under the worst possible conditions. There is an acute lack of competent and non-corrupt administrators who have sufficient information and authority to scrutinise potential buyers and beneficiaries. Even if a certain degree of conditionality is introduced in the form of binding contracts, it is questionable whether these can be enforced. If these states had not been so weak and captured by various entrenched interest groups there would have been no need for privatisation in the first place. There is much anecdotal evidence of major frauds in the privatisation process in the former GDR, despite very favourable institutional conditions (cf. Falkner 1994; Roesler 1995). The assessment of such criteria is unavoidable for an effective privatisation. The significance of constructing appropriate criteria cannot be overemphasised. It is not in the scope of this work to construct such criteria. The complexity of these distribution criteria which can be employed within a privatisation method is an advanced indicator of the likely result of privatisation. Therefore, it will be used in the following to evaluate privatisation methods.

(3) *Administrative costs*

Administrative costs incurred during privatisation comprise all expenses of the state privatisation agency and supporting institutions prior to and after privatisation.¹³ Administrative costs continue after the initial distribution as

¹² Multiple distribution criteria are used partially in the privatisation process of many PCPEs, e.g. in the former GDR (cf. Blommenstein, Geiger and Hare 1993: 30, Brücker 1993: 236-237); in the former CSFR (cf. Frydman et al. 1993a: 79); in Poland (cf. Frydman et al. 1993a: 186); in some tenders multiple distribution criteria with social connotations (e.g. employment maintenance, social programme) in the Russian Federation (cf. Frydman et al. 1993b: 61); in the Ukraine (Frydman et al. 1993b: 119); and in Latvia (Frydman et al. 1993b: 226). Vuylsteke (1988: 17, 90-91, 157-164) gives examples of mandatory procedures and guidelines used in several privatisation processes.

¹³ In most of the PCPEs some kind of state privatisation agency has been established. The function and authority of these ministries of privatisation, or state property funds as they are also sometimes called, vary from country to country. See Brabant (1992: 171-174) for a blueprint of a 'state asset management agency'. See chapter 5 for the Azerbaijani privatisation administrative framework.

information and monitoring costs. The more demanding the required framework and competence of administrators of a privatisation method are, the higher the administrative costs (e.g. in case of sale of shares through capital market operations a stock exchange and all its institutions have to be set up). In the following it is assumed that valuation costs arise in any case because of its indispensability.

(4) *Realignment costs*

As stated further above, the goal of privatisation will not be reached after an initial distribution of property rights. In the process of 'realignment' or redistribution of property rights costs will arise, which are part of the overall transaction costs.

(5) *Contract-type*

The contract can be either 'standard' or 'complex' (Brücker 1993: 64). The range of specification such as noted in the point distribution criteria obviously varies. The more complex a contract the more the future use of an enterprise can be predetermined. It can be expected that contract enforcement will prove difficult considering the fragile institutional framework in many PCPEs.

(6) *Economic competence*

Given asset specificity of enterprises, owners or their agents require relevant specific knowledge. Moreover, as discussed above, entrepreneurial 'tacit' knowledge is a scarce commodity and cannot be easily acquired by aspiring entrepreneurs.¹⁴ Levels of economic competence vary. It is difficult to measure in advance an entrepreneur's hands-on economic competence. This is possible through the experience given by success and failure. However, theoretically, a measurement of economic competence (e.g. managerial track records) could be included in the privatisation bargaining process. In the following analysis of privatisation methods a factor considered is the inclusion of such a criterion.

¹⁴ See section 1.1.

(7) *Potential capital contributions*

Scarcity of savings and the often questionable origin of funds available were already discussed above. The desired restructuring process should require significant capital investment. Therefore a privatisation method should be able to consider the financial potential of a buyer or beneficiary.

(8) *Insider-control*

One of the declared intentions of privatisation is the break up of patronage networks and the establishment of proper corporate governance structures - the prerequisites of hard budget constraints and static and dynamic efficiency. Ideally, insider elements should be removed from positions of control over enterprises.¹⁵ However, as discussed in section 2.3, a complete removal would be hardly realistic in a setting of political instability and weak governments. Often the mere attempt would be counter-productive as these powerful interest groups would destabilise the political conditions even more and would accelerate 'spontaneous privatisation' via asset stripping etc. Thus de facto property rights of insiders have to be taken into account. However, it would be desirable if initial control and ownership are transparent and moreover solely confined to enterprise or even plant level. This would be possible only by disrupting the insider-network, thus restricting insider-control. In the following, the effects of the various privatisation methods on insiders are assessed.

(9) *Agency costs*

Wherever ownership and control is separated, owners will face costs arising from the delegation of control rights to managers. Jensen and Meckling (1976: 308) define these costs as 'agency costs'. The latter comprise 'monitoring costs' of the principal, 'bonding costs' of the agent, and 'residual loss' occurring through the delegation (ibid.: 308). Agency costs can be regarded as transaction costs, as they arise in the process of reaching the goal of privatisation (cf. Williamson 1990:

¹⁵ For a definition of insiders, see section 2.1.2.1.

67f.).¹⁶ Increasing agency costs are created by dispersed ownership and unresolved corporate governance issues.

Table 3-2 summarises the methods of privatisation considered in the following.¹⁷ Often a mixture of methods is used: some shares are given away to the broad public, some are retained by the state, some sold etc.

¹⁶ Jensen and Meckling (1976: 308) suggest that potential buyers anticipate agency costs and include them in their offer.

¹⁷ See also Blommenstein, Geiger and Hare (1993: 16), Bornstein (1992: 287-300), Brabant (1992: 202-228), Brücker (1993: 61-95), Carlin and Mayer (1992: 3-9), Chilosi (1995), Davididi (1995: 11-22), Estrin (1994: 20-27), Frydman and Rapaczynski (1994: 148-167), Lavigne (1995: 155-178), Milanovic (1992: 50-65), and Wieners (1994: 93-156).

Table 3-2: Alternative methods of privatisation

Free transfer	Sale	Divestment of user rights
<ol style="list-style-type: none"> 1. Restitution 2. Free transfer to workforce and/or management 3. Free transfer to citizens <ol style="list-style-type: none"> (1) Vouchers for share auction (2) Shares in operating companies (3) Shares in investment trusts and other institutional endowments 	<ol style="list-style-type: none"> 1. Competitive tendering 2. Sale of shares through Capital-market operations 3. Public offering of shares 4. Public auction 5. Employee stock ownership plan (ESOP) and management buy out (MBO) 	<p>Leasing</p>

3.2 *Issues of valuation*

3.2.1 **The role of valuation in a PCPE context**

Issues and problems of valuation are fiercely discussed in the privatisation debate in PCPEs (cf. CCEET 1991; Frydman and Rapaczynski 1994: 16-20, 196-198; Birch 1993; Hulle 1993; Hervé 1993; Toltzman 1993). In all PCPEs there is also the concern that the nation's capital stock might be undervalued (cf. Kagarlitsky 1995: 84). Thus, valuation is strongly linked with the question of wealth distribution, already discussed above. The issue of valuation is often regarded as a mere obstacle to speedy privatisation. Some authors favour give-away methods so that valuation could be avoided (cf. Bim et al. 1994: 256-257; Wieners 1994: 71). Others argue that valuation could be simply carried out by foreign consultants in line with methods used in market economies. However, there are some significant deficiencies in this view. First, even in advanced market economies there are no standard blueprints for valuation of assets in the context of privatisation.¹⁸ Moreover, valuation methods used in market economies cannot be easily transferred to the context of PCPEs. This is due to the absence of reliable accounting data and other information, difficulties in determining applicable discount rates in the absence of financial markets, the lack of points of reference (i.e. data of comparable businesses), and the rapidly changing economic environment, to be discussed below. Thus, much insider knowledge and

¹⁸ There are basic rules dealing with the valuation of property, plant and equipment, e.g. in the European Community Articles 33, 35 and 38 of the 4th Directive of 25 July 1978 (Hulle 1993: 71). However, in most member States of the European Union, annual accounts presented for reporting purposes correspond to those for tax purposes. Thus, depreciation rates used do not necessarily reflect the reduction in value of the asset. And, the book value of assets may vary from the business value or the net realisable value. In case of privatisation, these book values have to be adapted and different business valuation methods are often used in addition. There is an abundant literature on both theory and practice of valuation in market economies. See for example, Ellis and Williams 1993 and Lee and Finnerty 1990.

subjective criteria are required, which outside consultants alone will not have. Or as Toltzman (1992: 65) puts it:

More than any other place or time in the world, valuations of investment opportunities in Central and Eastern Europe is an art, not a science. It demands judgmental conclusions requiring not only facts but also conceptual knowledge, extensive experience and a high degree of 'street sense'.

Second, as discussed in chapter two, privatisation should have the aim to initiate restructuring processes and the introduction of effective corporate governance where this is otherwise cumbersome in the present political setting. Due to the absence of market forces and asymmetric and imperfect information in the setting of PCPEs, an evaluation of the relative potential compared to alternative investment opportunities should guide the allocation of scarce resources. Factors have to be considered, such as potential product lines, markets, required capital expenditures and timing, organisational restructuring including the institution of inventory and administrative controls, competition, inflation etc. If such a valuation does not take place before or, at the latest, in conjunction with privatisation, time and resources will be wasted.¹⁹

Third, as pointed out in chapter two, old patronage networks and 'clientelist' pressure might perpetuate soft budget constraints for non-viable wasteful enterprises. Potential owners of the latter might build upon the 'political value' rather than the 'economic value' (Frydman and Rapaczynski 1994: 192) of their assets.²⁰ The valuation process could assist in isolating non-viable from viable capital stock. Assets with 'political value' could be dealt with separately. Instead of continuing soft budget constraints through subsidies and other privileges these plants or sections could be closed down with an adequate social plan to mitigate undue hardship. In many PCPEs it can be expected that clientelist pressures will fight off or postpone such closures. However, in the long run, the information gathered for the valuation can guide future industrial policy.

¹⁹ Frydman and Rapaczynski (1994: 16-20) recognise the relevance of valuation for the restructuring process.

²⁰ Frydman and Rapaczynski (1994: 192) give a steel mill based in a 'company town' as an example of an enterprise with 'political value'. 'Political value' could be also interpreted as 'rent-seeking potential'.

Fourth, as discussed before, in most PCPEs the highly centralised mechanism of enterprise control has fully disintegrated. With control of the ministries withered away, individual managers were left with omnipotent rights of control. It is not surprising that various criminals and Mafia groups have taken the opportunity of the control vacuum to asset strip to an extent which is unknown. There is much anecdotal evidence about plants where only a bare shell remained and where even the electrical wiring and water pipes were stolen. It is even not too farfetched to approximate the economic decline of Azerbaijan by a function including the number of truck loads of 'scrap metal' crossing the Iranian border. However, this kind of information is far too sensitive and life-threatening for the academic world. For a state or ruling elite which is committed to industrial restructuring and hence economic progress, it is important to regain control and challenge asset stripping, if not already too late. Valuation of SOEs can help these efforts.

To summarise: Valuation in the context of PCPEs should (1) assist the allocation of scarce investment resources, (2) guide future industrial policy, and (3) bolster against asset stripping. Finally, all the objective elements of valuation, which are available in a context of a developed market economies, are only at best partially obtainable in PCPEs. Thus, in the latter, subjective elements, which no doubt are used in any valuation, have to guide the assessments of enterprises in the transition period. This leaves the questions: (1) what are the strengths and weaknesses of presently used valuation methods, and (2) how can the deficiencies of these methods be alleviated?

3.2.2 Methods of Valuation used in Privatisation in PCPEs

The valuation techniques used can be divided into three groups, which are listed in Table 3-3 and assessed below.

Table 3-3: Valuation methods

1.	Methods based on the valuation of assets	<ul style="list-style-type: none"> • Net book value • Replacement value • Liquidation value
2.	Methods based on the discounted future cash flow	<ul style="list-style-type: none"> • Price-earnings method • Discounted cash flow method
3.	Other methods	<ul style="list-style-type: none"> • Market comparison method • Market entry method • Recent acquisition method

(1) Methods based on the valuation of assets

The most often used valuation methods in PCPEs are based on the net book value, i.e. the difference between the value of assets and liabilities derived from historical financial statements.²¹ These historical cost methods bear some crucial problems because of the absence of reliable historical financial statements. First, the original prices of plant and machinery were administered prices which did not necessarily reflect their real value. Rates of depreciation are mostly lower than equivalent rates in developed market economies (cf. Jermakowicz and Jermakowicz 1993: 15). Historical financial statements in PCPEs are distorted by factors such as price controls, subsidies, low interest loans, etc.

Second, accounting rules in a planned economy were designed to monitor the fulfilment of the economic plan. Thus, managers and their superiors in the ministries fearing the repercussions of failing the plan would, if possible, provide a picture of at least meeting the plan. As excess funds over the plan would be

²¹ In Russia the initial price of an enterprise for sale by tender or auction or the authorised capital of a joint stock company was determined on the basis of historical costs. The Russian valuation determining the initial price of the enterprises took the following factors into account:

- (1) original costs of fixed assets less depreciation, minus
- (2) the profit and economic incentive funds,
- (3) current liabilities and,
- (4) value of property covered by special privatisation arrangements, including social and other facilities designated to be transferred into state or municipal ownership (cf. Radygin 1995: 39).

For details on valuation in Azerbaijan, see section 5.2.3. For the Hungarian experience in valuation, see Borda (1993), Kerkes (1993), and Toltzman (1992). For a review of issues of valuation in Poland, see Jermakowicz and Jermakowicz (1993) and Jaruga (1993). For the Czech and Slovak experience, see Langr (1993). For the German experience, see Biener (1993), Steiner (1993), and Bracklo (1993).

taken away, it was often the practice to hide or disguise them (cf. Toltzman 1992: 63).

Third, in most PCPEs the control mechanisms have gradually broken down leaving enterprises in some countries without significant control for even up to seven years. This further reduces the reliability of existing historical financial statements.

Fourth, not all assets can be valued on the basis of historical costs. For example, in most PCPEs, the enterprises held only the user rights of land. Thus land has to be newly valued.²² The valuation of liabilities requires an assessment of the soundness of the enterprises involved. Potential environmental liabilities involves another valuation task.

The problems of valuation based on net book value can be avoided with methods based on replacement or liquidation value.²³ These methods have the drawbacks that (1) they are more time-consuming, as all assets have to be newly assessed and (2) there are no points of reference, e.g. comparable enterprises, liquidations etc. All methods based on valuation of assets do not reflect sufficiently the potential profitability and market value of a business. Hence methods based on the valuation of assets are inferior to more future oriented methods. However, for some smaller enterprises and those units which have to be liquidated methods based on the valuation of assets can be adequate.

(2) Methods based on the discounted future cash flow

The price-earnings (PE) and the discounted cash flow (DCF) methods are the most common techniques of this group. The PE method is based on the estimated sustainable earnings of a business and their capitalisation with a PE ratio that would be expected in the industry (cf. Birch 1993: 19; Ellis and Williams 1993:

²² This raises the need of land valuation criteria. For instance, the location of land and its immediate availability for construction should be considered (cf. Hulle 1993:73).

²³ Replacement cost valuation assesses the price at which assets can be replaced in their existing state. The liquidation value is the price which can be recovered, regardless of the book value, in case of liquidation.

255-259; Hervé 1993: 96).²⁴ However, in the context of PCPEs the determination of a comparative PE ratio is arbitrary, because of the absence of security markets, the general lack of data, and the economic and political uncertainty prevailing.²⁵ Birch (1993: 19) and Hervé (1993: 96) suggest that the PE ratios of comparable companies abroad or averages of several countries could be used allowing for a risk premium. Some prestigious enterprises could be valued this way. For the majority of enterprises this would be not, however, a solution.

The DCF method focuses the prospective cash flows in the forecast period²⁶ which are discounted with a discount factor²⁷ reflecting the expected rate of return (cf. Birch 1993: 19-20; Hervé 1993: 96; Toltzman 1992: 63-65). The prospective cash flows are based on a business plan. The latter should be in any case the first step of any restructuring. This might sound banal. However this was not general practice in Azerbaijan. The total value of the enterprises is calculated as the sum of the present value of the net cash flows, together with the residual value representing the resale price.

In both methods described the choice of the discount factor or the PE ratio respectively, are arbitrary in the context of PCPEs. The focus on cash flows rather than earnings might enable the timing of the return of investment to be determined more accurately (cf. Birch 1993: 19-20) and may be more useful in PCPEs. However, which method is more adequate depends again on the specific case. Both methods have the advantage that they are future-oriented valuations, requiring much consideration concerning the business plans of the enterprises. The

²⁴ The price-earnings ratio represents the current market price of a company share divided by the earnings per share (Ellis and Williams 1993: 255-257).

²⁵ Frydman and Rapaczynski (1994: 43) illustrate with an example of a valuation carried out by a Western consulting firm in Poland how high the potential valuation error can be. At an arbitrarily set PE ratio of 3 the value of the enterprise would have been US\$17 million, with a potential valuation error of US\$8 million. If the PE-ratio had been set at 4, the potential valuation error would have been US\$16 million, equalling 94 %.

²⁶ Toltzman (1992: 64) mentions a forecast period of at least five years, whilst Hervé (1993: 96) regards ten to fifteen years as adequate. Given the uncertain environment in PCPEs, even a period of five years is difficult to predict.

²⁷ The discount rate can be risk adjusted. The Capital Asset Model can be used to estimate the risk adjusted premium (cf. Hervé 1993: 96). Hervé (1993: 97) suggests that a country risk should be considered as well as a company specific risk. The latter could be approximated through an average of comparable enterprises abroad.

preparation of the latter necessitates the use of subjective elements and the participation of insiders of the enterprises in the valuation.

(3) *Other methods*

Other methods discussed in the literature are those based on (1) market comparison, (2) market entry, and (3) recent acquisitions (cf. Birch 1993: 20-21; Hervé 1993: 97). The market comparison method values an enterprise using data from comparable businesses. Criteria employed, such as earnings, depreciation, sales, etc. can be chosen according to sector, branch or specific enterprise. Again the problem is availability of data given the lack of developed capital markets. The method could be used with small businesses. In certain cases comparative data from enterprises abroad could be adjusted (cf. Birch 1993: 21).

The market entry method evaluates the cost of obtaining the market share of an enterprise, e.g. capital and human resource investments, and revenue losses during an initial period. The principle of this method should influence the valuation of former monopolistic businesses.

The recent acquisitions method calculates the value of an enterprise using data available from the sale of a similar enterprise. In the PCPE context the lack of (information on) comparable cases might be a obstacle. In branches where recent acquisitions have taken place, it could serve as a point of reference. On its own, the method lacks analytical power.

This section briefly summarised the strength and weaknesses of the methods presently under discussion and use. The choice of valuation method depends also to a certain extent on country, sector and enterprise specific factors. However, in medium- and large-scale enterprises future-oriented methods involve the preparation of a business plan, unless the enterprise is going to be liquidated. In practice, often several methods are used (cf. Frydman and Rapaczynski 1994: 41-43). The market entry method could for instance be used in addition to other methods in certain cases. A detailed analysis of these issues however, is beyond the scope of this work.

3.3 *Free Transfer*

3.3.1 Restitution

The privatisation programmes of most PCPEs, except for the CIS countries, consider restitution to individuals (or their heirs) and to institutions whose property was expropriated by the old regimes without compensation.²⁸ There are various forms of restitution possible including restoration of the property, cash compensation or compensation through equivalent assets or privatisation vouchers.

The moral and political justification for restitution is highly contentious. Some regard restitution as integral to the restoration of the 'Rechtsstaat', whilst others consider it blatant triumphalism. However, the potential level of transaction costs is enormous and a negative impact can be expected on both static and dynamic efficiency. First, the administrative costs of restitution are incalculable. Given that the expropriation was in some cases seventy years ago most assets are not available in their original form. Legal guidelines are essential to allow for the changes of assets. The identification of former owners or their heirs has proved to be very protracted, particularly in the context of competing claims and manipulated or poorly kept cadastres.²⁹ Setting a cut-off date for expropriation claims can also be highly contentious. This is the case with Jewish property confiscated by the Fascists before and during World War II (cf. Bornstein 1992:

²⁸ For a more detailed analysis of restitution see Bornstein (1992: 286-287), Brabant (1992: 116-119), Lavigne (1995: 172), Welfens (1992: 123-124), and Brücker (1993: 89-92). For a good evaluation of the Polish restitution process, see Wawrzinck (1994: 199-206). Sinn and Sinn (1991) give an assessment of the initial stages of the restitution process in the former GDR.

²⁹ Sinn and Sinn (1991: 77-78) give an example of a multiple claim situation in the former GDR where four legal claims exist. The Jewish owners of a little workshop were forced to sell their property to a local NSDAP member when they fled Germany. The latter abandoned this property, when he fled to West Germany after World War II. The new GDR state sold the workshop to a GDR citizen. In 1972 he was forced to sell it back to the state under the compulsory sales legislation. Shortly before reunification the property was resold to another GDR citizen under the existing privatisation legislation. According to Welfens (1992: 124) 1.3 million claims for restitution were already filed by the end of 1991 in the former GDR.

292; Lavigne 1995: 172). In most countries compensation is therefore preferred to restitution.³⁰

Second, the legal entitlement as sole distribution-criterion gives no indication of the managerial and financial capabilities of the newly determined owner. It is difficult to introduce additional distribution criteria.

Third, on equity grounds, the only possibility is a standard contract. No specifications about the property use can be included in the contract.

Fourth, there is no guarantee that the ownership of an asset fifty years earlier ensures economic competence. Obviously it is often the descendants who reclaim ownership. Economic competence is not an inherited ability.

Fifth, similarly one cannot assume that the previous owners will have the financial means to inject new capital into the business.³¹

Sixth, realignment costs can be expected to be high, because the new owners (particularly if inherited) often include diverse interest groups. Thus, the development of a business plan or divestment plan is often inhibited. This argument is strengthened considering that their share of the enterprise is practically a windfall. Their ability instantly to find a most profitable use is therefore questionable. It can be assumed that short-term gains, e.g. asset stripping, are preferred to long-term costly restructuring plans with considerable uncertainty.

Seventh, although the formal ownership rights are transferred to former owners, or more likely their descendants, it is likely that the new owners will not immediately have full control over their assets. However, restitution was used in Czechoslovakia to recapture control from the old managers (Lavigne 1995: 159).

³⁰ Welfens (1992: 123) describes how controversial compensation policy is in the former GDR. Individuals who came to West Germany from former German territories as refugees received compensation for their lost property from the budget financed 'Lastenausgleichsfond' (burden-equalisation-fund). Today they can claim compensation again for their property repaying the nominal amount of their original compensation received in the 1950s and 1960.

³¹ In Germany a law was introduced that former owners could only be physically restituted if they could guarantee higher investments than any competing bidder (Welfens 1992: 123). Otherwise they are compensated. However even this regulation proved to be inadequate to hold back previous owners with no investment intentions.

Eighth, agency costs depend on the size of the enterprise and the number of owners. Whilst they can be expected to be lower in smaller or medium sized enterprises they will be higher with the complexity and size of the operation.

Ninth, the time consuming restitution procedures impede potential change in the enterprises. Unresolved restitution issues will lead to further uncertainty for policy makers, potential investors and present workforce and managers. These caused delays in reorganisation and restructuring will have a negative impact on static and dynamic efficiency.

3.3.2 Free transfer to workforce and/or management

The participation of workers in ownership and/or control of their enterprises can take various forms. The best known are employee share ownership plans (ESOPs) with Mondragon co-operatives as an extreme variant and management buy-out (MBO) schemes.³² They can be categorised in several ways. First, one can distinguish between the labour-managed enterprise and workers' ownership (cf. Brabant 1992: 207; Saldanha 1992: 134). In the former, workers participate directly in the running of the enterprise and the residual income whilst in the latter ownership is separate from control.

Second, one can categorise into a non-divisible and individualised-share transfer of the property rights to the workforce (cf. Lewandowski and Szomburg 1989: 261; Radygin 1995: 20). At an individualised-share transfer, the individual worker is awarded with an equal share of the enterprise. At a non-divisible transfer the workforce collectively receives the enterprise.

Third, it is important for PCPEs to consider the degree of control over the management that the workforce obtains in the different transfer modes. Milanovic (1992: 58) warns that managerial abuses in the process cannot be externally controlled:

[...] If the management tightly controls workers' councils, it can ensure - through bribery, coercion or manipulation of information - that workers accept a privatisation proposal favourable to management.

³² For a detailed discussion of ESOPs and MBOs, see section 3.4.2 in this volume.

Privatisation through free transfer to the workforce is therefore often rated as an unfavourable 'nomenklatura take-over' (Bogetic 1992: 99; Chilosi 1995: 72; Frydman and Rapaczynski 1994: 61-62; Mandel 1995; Milanovic 1992: 58; Radygin 1995: 77).³³ As discussed in the last chapter, many PCPE enterprises have been de facto under sole management control in recent years. This was the case in Poland and especially in countries of the former USSR, where the centralised control mechanisms have been most drastically eroded. It was suggested above that these de facto property rights have to be taken into account in any privatisation, governance or restructuring decision. However, the bottom line is, if managers and their superior level of nomenklatura cannot be stopped from siphoning off revenues through asset stripping and illegal sales of raw materials and finished products, the enterprise's survival is seriously endangered. Moreover, the hardening of budget constraints and the avoidance of regulatory capture will prove to be very difficult, if patronage networks are not eliminated and proper corporate governance structures established. However, the success of privatisation through free transfer to the workforce and/or management depends on general political and economic parameters and many enterprise-specific factors. These are most eminently firm size, technology used, state of equipment, flexibility of production lines, and accessibility of input and output markets. The overall political and economic stability will determine whether managers are going to reinvest their illegally accumulated capital in their enterprises or at least in the country or rather take a risk-averse strategy by investing it abroad. Another very important factor for the success of the workforce/management privatisation is in how far the tradability of the individual enterprise shares is restricted. If there are no restrictions on outside share sales, the control of the enterprise is accessible to new investors. Moreover, if employees do not lose their shares in the enterprise once their employment is terminated, they might support long-term investment and restructuring in order to raise dynamic efficiency. A blockage period can be introduced, in order to avoid an initial extreme fragmentation of ownership. The

³³ Bogetic (1992: 99) refers to the experience in Poland, where most employee buy-outs have been nomenklatura take-overs. Many safeguards to limit the latter were taken in the privatisation legislation particularly of Hungary, Bulgaria and Romania (ibid.: 99).

latter would be undesirable in the restructuring period in which a strong commitment to restructuring and the long-term improvement of corporate management and control is required.

In the debate on privatisation, there is a broad rejection of employee ownership and particularly labour ownership.³⁴ The criticism is mainly based on two lines of reasoning. First, a free transfer to the employees is regarded as inequitable as parts of the population which have also contributed to capital accumulation are not considered and employees of poorly-endowed, loss-making firms are disadvantaged.³⁵ There is a fear that a privatisation to insiders could be perceived as *nomenklatura* privatisation and cause widespread political discontent and resistance to the whole process.³⁶ However, as Estrin (1994: 25) points out quite rightly, this is the case with any insider privatisation. Weitzman (1993: 252; 254) responds that privatisation would be inequitable in any case and that, of all options, 'squatter sovereignty' would be the best:

[..] Any principle of distribution is going to be attacked as unfair, and squatter sovereignty seems to me as defensible a general position as can be taken. Let those who work the land and the machines own them, at least initially.

In order to offset resulting inequalities, Weitzman (1993: 254) suggests the creation of a 'well-managed progressive tax system'. Bogetic (1992: 90) makes an important proposition concerning the equity argument, stressing that each privatisation scheme can be regarded as unjust and that *ex ante* perfectly egalitarian distribution can turn out to be *ex post* non-egalitarian (e.g. through asymmetric information in trading of shares).³⁷

Second, labour-managed firms are accused of a labour-income bias (cf. Brabant 1992: 207; Estrin 1994: 25; Wieners 1994: 102). In the case of pure

³⁴ For instance, see Brabant (1992: 207-208), Chilosi (1995: 81), Estrin (1994: 24), Frydman and Rapaczynski (1994: 25-26), Kornai (1990: 90), Milanovic (1992: 58), and Wieners (1994: 97).

³⁵ For instance, see Brabant (1992: 208), Chilosi (1995: 81), Frydman and Rapaczynski (1994: 25-26), Kornai (1990: 90), Milanovic (1992: 58), and Wieners (1994: 97).

³⁶ Public discontent with '*nomenklatura*' privatisations has led to more state supervision in the privatisation process in Hungary and Poland (cf. Bogetic 1992: 99, Estrin 1994: 25).

³⁷ This position is also taken by Heinrich (1994: 49).

management ownership this is seen as avoidable (Estrin 1994: 25). Moreover, employees are assumed to oppose any restructuring leading to a change in the status quo (Estrin 1994: 25; Wieners 1994: 104). However, these arguments are purely based on assumptions or evidence from the Yugoslav 'contractual' form (Saldanha 1992: 138) of self-management, which differs from the type of employee-ownership discussed in the context of the recent privatisation campaign in PCPEs (cf. Bogetic 1992: 89; Brabant 1992: 207; Saldanha 1992: 138-139).³⁸ The development of a labour-wage bias depends also on the tradability of shares and the form in which workers participate in profit (cf. Wieners 1994: 102), control and other factors.³⁹ In Azerbaijan, the majority of workers have put up with irregular and low pay expecting that payment conditions might change once the initial transition period is overcome. Similarly, one could hypothesise that worker-owners, who are likely to be less mobile than managers, would accept broader sacrifices to guarantee the survival of their enterprises as a continuing source of employment and income. However, these are all speculations which strongly depend on general political and economic conditions and firm-specific circumstances.⁴⁰

³⁸ Saldanha (1992: 138-139) identifies four ways in which the Yugoslav contractual form of self-management differs from the theoretical labour-management model: degree of state intervention (i.e. soft budget constraints); existence of Co-ordinating mechanisms and monopolisation; dependence of decision making on political division between republics; link between banks and enterprises and the lack of financial discipline (i.e. soft budget constraints).

For a detailed account of the Yugoslav model of labour-management, see Estrin, Moore and Svejnar (1988), Obradovic and Dunn (1978), and Saldanha (1992).

³⁹ Employees who lose their share of the enterprise once their employment is terminated might have a stronger labour-income bias. They are more likely to prefer short-term higher income to long-term investment with long-term returns.

⁴⁰ The stated assumption is not explicable by purely 'rational' economic considerations. However, historically, it does not seem to be too far-fetched if one considers the enormous sacrifices made in the post-revolution and post-World War II period in the Soviet Union, and also in capitalist economies such as the restoration period in West Germany and Japan.

Of those who are in favour of a free transfer to the workforce, Weitzman (1993) presents the most compelling arguments.⁴¹ As initial distribution, he prefers 'squatter sovereignty' to 'far fetched mutual-fund-like' distribution schemes. Weitzman (1993: 262) stresses the 'constructive countercyclical role' of worker-ownership in a capitalist economy:

The employee buyout can play a very significant practical role in easing the transition from unprofitability to profitability, or, conversely, from profitability to unprofitability.

His theory is based on the assumption that worker-owners are more willing to accept temporary pay cuts in the transitional period. Through the prevailing economic pressures the wage rate remains lower in the worker-owned sector and major restructuring can be carried out benefiting from the advantages of initial worker-ownership: (1) concentrated ownership; (2) avoidance of "us vs. them" stalemates;⁴² (3) less likely occurrence of regulatory capture; (4) greater acceptability of hard budget constraints; and (5) less opportunity for financial manipulation (Weitzman 1993: 267). Weitzman stresses that eventually, worker-owned enterprises develop into capitalist enterprises. Worker-owners either (1) seek other opportunities in the capitalist sector, if the wage-rate plus dividend is less than the average wage rate in the economy, or (2) if the marginal value of labour exceeds the average wage rate, outside workers are hired to average wages until the two are equal.

In the Russian Federation most small-scale municipal enterprises were bought out by their work collectives. Mandel (1995: 38) argues however, that the latter were often only fronts for the directors of the enterprises or outsiders including Mafia. In the privatisation of medium and large enterprises, these included in the process could opt for one of three modes:

⁴¹ Weitzmann's plea for workers' ownership was taken up by many Russian economists in the Russian privatisation debate. Proponents of this view have been amongst others A. Boiko, V. Cherkovets, T. Popova, V. Tarasov, and E. Yasin (Radygin 1995: 20-22).

⁴² For effects of workers' participation on the distribution struggle between capital and labour, see also Bradley and Gelb (1983: 42).

- (1) Employees receive 25% of the enterprise's equity in preferred, non-voting shares.⁴³ They additionally can subscribe for 10% of voting equity on favourable terms.⁴⁴ Managers have the option to purchase another 5% of voting equity.⁴⁵
- (2) Employees are given a right to acquire 51% of the voting shares for 1.7 times the book value (as 1 July 1992).
- (3) A workers' committee or the management has to commit itself to carry out a privatisation plan giving a guarantee for a certain number of jobs and against bankruptcy. After one year, the members of this committee or the management can acquire 20% of the voting shares at face value. Additionally, all employees have the right to buy 20% of the voting shares at a 30% discount at face value. For various reasons this option has rarely been used.⁴⁶

About three quarters of workers' collectives⁴⁷ opted for the second option (Mandel 1995: 41). However, the effectiveness of workers' control over management is doubtful in the Russian context. First, the board of directors is made up one representative of the local property fund, one representative of the local authorities, the general director, and a representative of the workers (regardless of the proportion of shares held by latter) (cf. Mandel 1995: 40; Radygin 1995: 63; Webster et al. 1995a: 29). Thus, workers have only small influence on decisions concerning the enterprise. The findings of a survey carried out in 92 newly privatised enterprises in the Russian Federation conclude that the control of managers is limited (Webster et al. 1995a: 29). Mandel (1995) reports a case where trade union influence and workers' influence were defeated by open

⁴³ Non-voting shares per employee are limited to the equivalent of 20 minimum monthly wages.

⁴⁴ The value of the voting equity per employee are limited to the equivalent of six minimum wages.

⁴⁵ Additional voting equity for managers is limited to the equivalent of 2000 minimum wages.

⁴⁶ For further details of the three privatisation options, see Lieberman and Rahuja (1995: 14) and Radygin (1995: 123).

⁴⁷ Workers' collectives comprise all employees working within a given enterprise except for the top executive level.

violence. Due to the weakness of the law enforcement agencies, it is difficult to combat such incidents.

Second, the block of workers' shares eroded quickly after the closed subscription. Radygin (1995: 77) notes that managers were able to attain 15 to 25% of the shares through (1) applying for a proportional distribution of shares, (2) buying out shares of the workforce, (3) buying vouchers at auctions (sometimes by using dummy-firms).

Finally, due to lack of funds, employees are not able to acquire further shares on secondary markets.

Having looked at the debate on free transfer to the workforce and/or management and some empirical evidence, the potential level of transaction costs and impact on both static and dynamic efficiency will be evaluated below. First, administrative costs can be expected to be low (cf. Lee 1991: 23). There is a readily identifiable group of buyers and no need to develop capital markets (cf. Bogetic 1992: 89). As the political acceptance of such privatisation will be high, the whole process can be expected to run more smoothly. Moreover, monitoring and information costs will be low as the initial ownership and control structure is fairly transparent.

Second, depending on the restrictions imposed on sale, realignment costs could be low. Weitzman (1993: 254) highlights 'a well designed system of ownership', defining titles and their transfer procedures, as crucial for the success of the privatisation process. Transfer procedures do not necessarily require sophisticated capital markets, which is a further indicator for low realignment costs.

Third, it can be assumed that employees are those who are most familiar with internal slacks, technological constraints and hence opportunities for the enterprise. Therefore, economic competence of the assigned owners can be expected to be high. This, however, is also dependent on the degree of ownership participation of workers and middle management. If the latter are sufficiently considered in the ownership structure, there is immense scope for an exemplary use of insider knowledge.

Fourth, potential capital contributions of the workforce can be considered to be low. This might be different for some managers, who had the opportunity to accumulate considerable capital illegally. Whether a free transfer of the enterprises encourages them to reinject these funds is difficult to predict and entirely dependent on specific case material.

Fifth, this privatisation mode would clearly and directly benefit insider control. However, it depends on the degree of ownership-participation of the workforce and middle management in determining how far short-sighted opportunistic behaviour can be curbed and possible incompetent or dishonest management dislodged. This privatisation method bears an advantage over others in its transparency. Whereas in other modes insiders exercise control indirectly, here initial control and ownership is transparent and, moreover, solely confined to enterprise or even plant level. In other privatisation modes, long appendages of industrial nomenklatura, originating from former branch ministries, industrial associations and municipalities, and newly emerging bankers and speculators participate in control and ownership or are essential to managers' control. Large parts of these 'appendages' only pursue short-sighted opportunistic interests with the intention of plundering the resources of these enterprises (cf. Kagarlitsky 1995a: 90-91). This privatisation mode provides some scope to loosen enterprise-level or even plant-level management from its nomenklatura-structure. A privatisation at plant-level would be preferable to one at enterprise-level in this respect. The dispersed plant managers, whose interest would not be homogeneous either, would be less powerful as a lobbying group.⁴⁸ The whole patronage-network would be weakened significantly, as formerly united interest groups, consisting of the entire industrial nomenklatura, would be divided.

Sixth, agency costs can be expected to be low. The problem of asymmetric information is hardly prevalent (cf. Hansmann 1990: 1768). In case of broader worker-participation, control amongst workers will be enhanced and shirking

⁴⁸ Depending on their capital endowment, enterprises have differing interests in restructuring. Those who have no potential for survival are certainly more interested in state subsidies and maintenance of the status quo.

lessened (cf. Caves 1990: 163). Resources set aside for control could be reduced (cf. Fusfeld 1983: 769).⁴⁹

On the whole, a free transfer to workforce and/or management causes relatively low transaction costs. The transparency of the mode bears advantages. De facto ownership rights are considered. Patronage-networks could be curtailed through the division of interests. If the power of the workforce would be increased, control on dishonest or incompetent management could be strengthened. Finally, the economic competence of workforce and managers is higher than that of any other potential owner.

3.3.3 Free transfer to citizens

Mass privatisation, in the form of free distribution of shares to citizens, has been very popular.⁵⁰ Under this approach, citizens directly receive shares of enterprises, or indirectly they receive vouchers or coupons entitling them to swap these for the latter. Before enterprises can be privatised in this way, they must undertake a process of 'corporatisation' in which they are turned into joint-stock companies.

In former Czechoslovakia every citizen over the age of 18 could buy for an administrative fee of 35 korunas (about US\$ 1) coupons entitling them to a total of

⁴⁹ Bradley and Gelb (1983: 62) stress that in Spanish Mondragon-Co-operatives managers are more strictly controlled than in comparable businesses.

⁵⁰ Give-away schemes in their different variations have taken place or are envisioned in Armenia, Belarus, the Czech republic, Estonia, Kazakhstan, Latvia, Lithuania, Moldavia, Poland, Romania, the Russian Federation, the Slovak Republic, and the Ukraine. For an analysis of the Czech privatisation process see, Carlin and Mayer (1992), Frydman et al. (1993a: 40-94), Hrnčir (1995), Grosfeld and Hare (1991), Mladek. (1994), Parker (1993) and, Takla (1994). The Polish privatisation process is reviewed by Frydman et al. (1993a: 148-209), Gomulka and Jasinski (1994), Grosfeld (1990), Nuti (1993, 1995), and Poznanski (1993). There is extensive literature on the Russian mass privatisation process. See, for example, Akamatsu (1995), Bell (1995), Bim, Jones, and Weisskopf (1994), Boycko, Shleifer, and Vishny (1994), Boycko and Shleifer (1995), Chubais and Vishnevskaya (1994), Frydman et al. (1993b: 4-82), Giles and Buxton (1995), Hendley (1992), Lieberman and Rahuja (1995), Lissovolik (1995), Mandel (1995), Radygin (1995), Sachs (1992), Schwartz and Nelson (1995), Sheppard (1995), Vacroux (1995), Volgin and Milner (1995), and Webster et al. (1995a and b).

1,000 'investment points' (Mladek 1994: 146-147).⁵¹ The latter were only valid when registered. The whole process was controlled by a central computer. Participants could either exchange their coupons against shares in the various privatisation rounds or they could transfer their investment points to an investment fund. Beginning the first round, one share was priced at 33 1/3 investment points and a face value of 1000 korunas. In later rounds the price was changed rather arbitrarily by a special committee of the Federal Finance Ministry (Mladek 1994:147). In the first 'wave' of coupon-privatisation lasting from March to December 1992, 1491 joint-stock companies participated with an average of 67% of their shares in the programme (Mladek 1994: 150).⁵² Whilst in the first four months only two million of the eligible 10,5million adults bought their coupons, towards the end three-quarters participated (Liebermann and Rahuja 1995: 15-16).

In Poland a mass privatisation programme similar to the Czechoslovakian, based on shares in investment funds for citizens, showed little success in its first 'wave' (Heinrich 1994: 54; 63).⁵³ Of the 182 enterprises designated for the first privatisation 'wave' no privatisation was completed by mid 1993. The 'liquidation' programme was more significant in the Polish privatisation process.⁵⁴

In the Russian Federation, vouchers representing federal securities with limited validity and a face value of 10,000 roubles⁵⁵ were distributed to the citizens for a fee of 25 roubles (cf. Radygin 1995: 58; Lieberman and Rahuja

⁵¹ The Czech coupon-privatisation was based on Svejnar (1989) and refined by Dusan Triska, who also designed the software which controlled the programme (Mladek 1994: 145).

⁵² Mass privatisation via coupons was only one of the methods used in the 'large' privatisation process of former Czechoslovakia. Other methods used on their own or combined include sales through auctions and tenders and transfers to municipalities, pension funds and health care institutions (Frydman et al. 1993a: 80). On the whole, a case-by-case approach was taken in the former Czechoslovakia.

⁵³ For details on the Polish mass privatisation programme see, for example, Frydman et al. (1993a: 194-197).

⁵⁴ For an exposition of the Polish privatisation programmes, see Frydman et al. (1993a: 148-209), Gomulka and Jasinski (1994), Grosfeld (1990), Nuti (1993, 1995), and Poznanski (1993).

⁵⁵ 10,000 roubles equalled two and a half bottles of vodka by the end of the deadline for the use of the vouchers (Mandel 1995: 39).

1995: 15).⁵⁶ Vouchers were freely tradable in exchange for money.⁵⁷ 97% of voucher were collected by the end of June 1994. From 1 December 1992 till 1 July 1994 on shares of 15,779 enterprises were placed in auctions in 86 regions of the Russian Federation.⁵⁸ The minimum of shares which had to be put up for auction by law was 29% (Schwartz and Nelson 1995: 65). However, on average only 18,9% of total shares were offered on auctions (Radygin 1995: 68). Including the shares sold in closed subscription to employees, on average 71% of shares were exchanged for vouchers, even though 80% of shares were required to be sold by regulation (Radygin 1995: 69). By the end of the deadline for use of the vouchers 104 million vouchers had been exchanged for shares on voucher-auctions, and 40 million on closed subscription for employees of joint-stock companies (Radygin 1995: 116).

Large scale privatisation was already planned by Gorbachev's administration in 1990.⁵⁹ One of the initial programmes attempted to transfer SOE property rights directly to the Branch ministers (cf. Mandel 1995: 39). However, such blatant favouritism of the *nomenklatura* was politically embarrassing for the Yeltsin regime; a regime which came to power promising to 'defend the ordinary people against the *nomenklatura*'. The programme which was actually implemented, was designed within the bounds of political feasibility to speed up the privatisation process (cf. Lieberman and Ruhuja 1995: 10-12). The strategy

⁵⁶ Vouchers were originally valid from 1 December 1992 to 31 December 1993. Due to delays in the process the deadline was extended to 1 July 1994 (Lieberman and Rahuja 1995: 15).

⁵⁷ Whilst the Russian vouchers were interchangeable with money, the Czech coupons could only be exchanged against shares. Thus the Russian variation stands for a short-term monetary expansion, whilst the Czech for an emission of cash substitute for the purchase of shares.

⁵⁸ These 15,779 enterprises hold in total 1.1 trillion roubles authorised capital (in old book values) and 16 million employees (Radygin 1995: 116). According to the Russian State Committee for the Management of State Property (GKI), there are 212,000 small (up to 200 employees), 22,000 medium-size (200-1000 employees), 8,700 large (1000-10,000 employees), and 100 giant (over 10,000 employees) SOEs in the Russian Federal Republic (cf. Radygin 1995: 112).

⁵⁹ Radygin (1995: 20-26) gives an account of the debates preceding privatisation. Adherents of the voucher approach were mainly O. Bogomolov, P. Bunich, P. Filipov, M. Malei, L. Piyasheva, G. Popov, and V. Rutgaizer. However, when it came to the practical implementation of the programme, many of its supporters became critical (Radygin 1995: 26).

was a compromise between the various interest groups in order to limit public protest against privatisation and to preserve the privileges of the nomenklatura.⁶⁰ The outcome was very favourable to the nomenklatura, as described below. Radygin (1995: 50) puts it:

[..] what we have today is a version of turning state property over to private hands that is optimal for the nomenklatura; practically no responsibility for property, and an exceptionally thin line separating what is from what is not one's own.

There are mainly three schemes for packaging the distribution of shares:

(1) Vouchers for share auctions

In this scheme eligible citizens receive in equal shares some kind of "monopoly" money, which entitles them to bid for enterprises on specially arranged auctions. A citizen can use all his/her vouchers to bid for shares of one enterprise or can diversify by bidding over a range of enterprise shares. The bidding process establishes a surrogate for a market valuation of the enterprises, a "voucher unit" valuation.⁶¹ There are several drawbacks to this procedure, most of which are also applicable to the other distribution schemes. First, the effect of imperfect and asymmetric information for outsiders increases the problem of accurately assessing potential profitability of enterprises. The poorly functioning capital markets reinforces these valuation problems. Moreover, severe agency problems are already likely due to wide ownership dispersion, an intentional result of the voucher-programme (cf. Jensen and Meckling 1976: 315-318).⁶²

Second, accordingly, the value of the vouchers will not necessarily relate to the profitability of enterprises. The price is more dependent on political factors,

⁶⁰ Frydman and Rapczynski (1994: 5) state that in the Czech context 'company managers expected that voucher privatisation would lead to a wide dispersion of ownership and allow them to maintain control'.

⁶¹ Radygin (1995: 60) gives an example of this procedure in the Russian Federation: For example, the voucher auction price of one share in the Bolshevik factory was one voucher, so with a market price for the voucher at 6000 roubles a share with a nominal value of 1000 roubles can be valued at 6000 in 'voucher money', and the statutory capital of the company is similarly valued at six times the nominal figure.

⁶² The initial analysis of the Russian voucher-privatisation programme is uncertain whether the latter led to wide ownership dispersion (cf. Mandel 1995, Radygin 1995).

inflation, and speculation.⁶³ The Russian voucher prices fluctuated wildly (cf. Radygin 1995: 59; Chubais and Vishnevskaya 1994: 96). In different regions of the Russian Federation, there were marked variations in the difference between the actual voucher price and an estimate of the fixed assets (in historical costs less depreciation) of enterprises, which led to further speculative trading (Radygin 1995: 60-61).⁶⁴ Moreover, voucher investments in the Russian Federation were concentrated on only a few sectors of Russian industry (cf. Radygin 1995: 65). By analysing the voucher-valuation as an entity, it becomes clear, that Russian industry was undervalued by this process (cf. Lieberman and Rahuja 1995: 22).

Third, most PCPEs are experiencing prolonged bouts of political instability. When this is combined with an inadequate legal framework and malfunctioning law enforcement agencies, the opportunities for speculative, criminal and fraudulent activities increase.⁶⁵ All privatisation methods can experience these problems, but it is particularly prevalent in voucher-privatisation schemes, because of the lack of transparency in the transfer of ownership.

Finally, because of the speculative activities introduced through voucher-privatisation, it can be expected that this primary distribution of ownership rights will pass through many privatisation stages until serious investors become involved. In the meantime it is very unlikely that proper corporate governance structures are established and restructuring is initiated. In all this time enterprises

⁶³ For example, according to Radygin (1995: 59) there were speculative windfall profits made through exploiting the differences between cash and non-cash rates of vouchers.

⁶⁴ Radygin (1995: 60) points out:

It is essential to note that in only 20% of the regions were the values of privatisation vouchers and fixed assets estimated to be balanced. For example, while vouchers coverage of assets was only 53% in North, 58%, in Eastern Siberia, 76% in the Central and Black Earth area, 78% in the Far East and 92% in the Povolzhie area, in the Urals the voucher excess was 3%, in the North-West 8%, in Northern Siberia 21%, in Volga-Vyatka 22%, in the Central Area 25%, and in the Caucasus 67%.

⁶⁵ Such activities are for example the buying up of shares through enterprise managers themselves through dummy firms. Radygin (1995: 66) quotes as an example the Russian Federation's largest motor industry giant, which used 15 dummy firms and over 1 million vouchers to buy back their own shares. Radygin (1995) suggests that state-owned funds were used for these transactions. Other examples are that unwanted investors are prevented from taking part in voucher auctions. For instance, in some regions of the Russian Federation local authorities illegally suspended voucher-auctions and only conducted cash auctions (Radygin 1995: 49-50). Or formally open voucher auctions were held on closed industrial territory (Radygin 1995: 66).

are exposed to severe uncertainty and left without proper control. Many enterprises are unlikely to survive this period. Radygin (1995: 79) suggests that in the Russian Federation the money privatisation process will create something more like an intermediate ownership structure. But even then, this ownership structure will be unstable due to political circumstances.⁶⁶ Estimates range between 1.5% (Veteran investment fund) and 6% (Russian State Committee for the Management of State Property) of the population in the Russian Federation, as participants in this privatisation process (Radygin *ibid.*). This is far from the ambitious expectations of a popular capitalism.

(2) Shares in operating companies

In this distribution scheme eligible citizens directly receive shares in operating companies. This could be in the form of a portfolio of shares of a variety of different companies. Different portfolios could be created with equal book value. Bornstein (1992: 295-296) suggests that one possible way of distribution is to create ten different portfolios. The last digit of the national identity card number would determine which portfolio one receives.

This distribution mode would avoid voucher-auction markets and speculative dealing with vouchers. At the same it would cause a wider dispersion of ownership and it would be more difficult for serious outside investors as well as insiders to acquire a controlling block of shares.

(3) Investment trusts and other institutional endowments

In a third mode investment trusts could be set up holding a portfolio of shares of different enterprises. Each eligible citizen could then obtain free shares of one investment trust or a portfolio of different investment trusts.

⁶⁶ Property rights cannot be guaranteed. A foreign investor who acquired two-thirds control over the entire aluminium capacity of the Russian Federation, lost his/her 20% interest in the Krasnoyarsk Aluminium plant through a decision of the local authorities (FT 15 Feb 1995).

Some proposals suggest institutional endowments as a vehicle of privatisation.⁶⁷ All schemes comprise three components: (1) enterprises are corporatised, (2) shares are issued and distributed in various institutions, (3) shares of these institutions in turn are either given or sold to the broader public.⁶⁸ Proponents of such an approach believe in the decentralised market forces of capital markets. They assume that stock markets etc. are likely to develop quickly. There are two types of institutions mainly considered:

(1) Mutual funds are an investment instrument to manage a portfolio of stock-exchange securities. As passive investors they do not take a controlling interest in their enterprises and do not actively initiate restructuring processes. Mutual funds are supposed to exert indirectly discipline on managers by 'voting with their feet'. A precondition for their operation are functioning stock markets - which are in infant stages in all PCPEs. However, advocates of this approach assume that the latter will develop fast, and it is hoped that mutual funds will stimulate this process.

(2) Holding companies have in principle the advantage over mutual funds that they exercise direct control over enterprises including active involvement as in the initiation of restructuring and the appointment of management. Depending on the size of a holding company its shares are intrinsically less risky and therefore attractive for small investors. However, in the context of PCPEs it can easily happen that holding companies serve as front organisations for the old branch ministry system and its appendages. This is already happening in the FSU (cf. Radygin 1995). Thus, there is the danger that soft budget constraints remain and that restructuring will not be initiated.

In the Russian Federation two kind of private investment funds emerged out of the voucher privatisation: (1) voucher and (2) non voucher funds.⁶⁹ These

⁶⁷ For privatisation proposals suggesting institutional endowments see, for example, Blanchard et al. (1991), Bornstein (1992), Dhanji and Milanovic (1991), and Frydman and Rapaczynski (1994).

⁶⁸ The details of schemes differ in the distribution of shares and in which recipients they consider for shares.

⁶⁹ For details on Russian investment trusts, see Giles and Buxton (1995), Lieberman and Rahuja (1995: 17-20), Radygin (1995: 67-710, and Volgin and Milner (1995).

investment funds are operating under the new and therefore weak regulatory framework mainly based on the Presidential decree of 7 October 1992 'On Measures to Organise a Market for Securities in the Process of Privatisation of State-Owned and Municipal Enterprises' and the Investment Company Law in 1993 (cf. Lieberman and Rahuja 1995: 17; Radygin 1995: 67). According to this legal framework, voucher funds are licensed and regulated by the GKI and non-voucher ones by the Ministry of Finance. From end 1992 to June 1994 the number of investment funds rose from 34 to 630 (mainly voucher funds) (cf. Lieberman and Rahuja 1995: 17; Radygin 1995: 68). In total these funds had acquired 45 million vouchers and 25 million share holders (Radygin 1995: 68). There are a number of problems in the development of the Russian investment funds which are mainly linked to their poor regulation. First, liquidity problems are prevalent, because voucher funds are by decree close-ended and secondary markets are poorly functioning.⁷⁰ Thus the shareholders' ability to 'vote with their feet' is limited (ibid.).

Second, most funds are involved in heavy speculative activities (cf. Radygin 1995: 69; Volgin and Milner 1995: 58-59). Speculative profits were made, for example, (1) through the difference between auction and post-auction prices, (2) through sale of accumulated vouchers,⁷¹ (3) through share buying for outside clients (mainly for the management of enterprises who want to acquire control over their enterprises) (cf. Radygin 1995: 69).

Third, Volgin and Milner (1995: 60-61) point out that fund managers prefer to diversify their activities to real estate trade and more unregulated areas of investment and financial services than actual fund managing. Moreover, Radygin (1995: 79) points out that a considerable part of shares held by investment funds is still intended for resale. Many investment trusts have no long-term interests in their enterprises and, hence, are unlikely to initiate restructuring.

⁷⁰ Lieberman and Rahuja (1995: 19) report that some funds have semi-continuous subscription periods and are therefore more open-ended.

⁷¹ A Presidential decree of May 1993 'On Guaranteeing the Rights of Citizens in the Course of Privatisation' tried to abolish the speculative sale of accumulated vouchers by investment funds (cf. Radygin 1995: 25).

Fourth, agency problems apply to the investment trusts themselves due to wide dispersion of ownership. Thus fund managers are likely to pursue their own interests. This again is exacerbated by a weak regulatory framework.

Fifth, because of the fragile regulatory framework many fraudulent funds emerged, which collected money and vouchers and subsequently disappeared (cf. Volgin and Milner (1995: 56).

Sixth, many small investment funds lack expertise and liquidity even to cover their overheads (cf. Radygin 1995: 69-70). Both Radygin (1995: 70) and Volgin and Milner (1995: 61) predict that many are going to merge; however, the majority are going to go bankrupt. The lack of a functioning regulatory framework makes the protection of shareholders doubtful.

All in all the potential level of transaction costs are high in these 'free-transfer' schemes and the impact on both static and dynamic efficiency of the enterprises privatised in this way can be expected to be negative. First, administrative costs are very high. This is especially the case with the vouchers for share auction variant. Practically non-existent capital market and thus the lack of essential information concerning the valuation of enterprises for outsiders makes investment decisions problematic. The formation of adequate investment trusts, mutual funds, and holding companies can be very time-consuming. As described before, there is the danger that the personnel and the structures of the old branch ministries and industrial conglomerates will establish themselves in the new holding institutions. Moreover, a sound regulatory framework has to be established in order to reduce fraudulent activities and easy manipulation, and again illiquidity of capital markets limits shareholders' ability 'to vote with their feet'.

Second, the Russian experience has already shown, that even an intermediate ownership structure which could already initiate some restructuring has not been established especially in many of the larger enterprises after the 'mass' privatisation phase. It could take years before the battles of redistribution over property rights will result in owners with long-term interests in their enterprises. The overall political and economic conditions will heavily influence this development.

Third, wide dispersion of ownership and imperfect and asymmetric information clearly favours the control of insiders. It is unlikely that small investors will be able to exercise control over management. They lack the economic competence and are unable to achieve the co-ordination needed to monitor management effectively. Poorly functioning capital markets will be not able to give reliable information about enterprises. A fragmentary legal framework and weak law enforcement agencies, reinforces insider control, as seen in the Russian Federation. The variant using intermediaries such as investment funds and other institutions will not solve these agency problems. The question arises who will monitor the monitors? Both managers of intermediaries such as investment funds and of the enterprises themselves will hardly be restraint in their actions.

3.4 Sale

3.4.1 Competitive tendering

Discretionary procedures for closed and limited tenders have been particularly popular in the privatisation process in the former GDR.⁷² It is a privatisation method which requires a developed and firm legal framework with speedy means of contract enforcement and expertise within the privatisation institution. If the latter were present, it could be a useful measurement of industrial policy. However, because of its lack of transparency, the privatisation method requires considerable resources for monitoring of the privatisation institution and contract enforcement. The advantages and drawbacks will be considered in the following within the given framework. First, multiple distribution criteria can be used in choosing the potential buyer. These criteria could be attuned to industrial policy in different sectors. Relative transparency could be guaranteed if guidelines were set

⁷² For details on the use of closed or limited tenders in the former GDR, see Treuhand (1991).

for the procedures of the privatisation agency and the different criteria were clearly shadow-priced.

Second, administrative costs are relatively high as indicated above. The assessment of different proposals and negotiations with the different bidders requires competent agents in the privatisation institutions and can be very time-consuming. The problem of asymmetric information between insiders and agents of the privatisation institution will strengthen the bidding advantage of the insider. As multiple criteria are pursued, agents have considerable discretion in their assessment and negotiations. Hence, the privatisation institution or any other institution involved in the process requires close monitoring. Similarly, successful bidders have to be monitored, so that they keep to their agreed commitments and, accordingly, contracts have to be enforced.

Third, complex contracts are required which can ensure a favourable privatisation outcome. However, their arrangement is more time-consuming and they require effective enforcement. In most of the PCPEs the legal framework and the law enforcing institutions are still fragile and weak.

Fourth, realignment costs can be expected to be high, as it may be difficult to attract alternative bidders again once one initial restructuring plan has been unsuccessful and the original form of an enterprise has been changed.

Fifth, the economic competence of buyers can be assessed in their proposals. Thus, distribution should be less of a gamble. Similarly potential capital contributions can be assessed prior to the privatisation.

Sixth, depending on the degree of domestic and international publicity and, of course, the state of the assets themselves, more outside bidders could be attracted. If the tendering was organised competitively, outsiders could participate in the process. However, insiders have the advantage of prior access to information. If these insiders can also claim de facto property rights, the likelihood of outsider bidders is reduced. In theory, multiple distribution criteria could help to guarantee a successful outcome of the privatisation process. And if proposals and the background of bidders are carefully scrutinised, fraudulent bids could be detected. However, the success of this privatisation method depends on the degree

of authority and integrity of the privatisation institution, i.e. whether it can defeat pressure from powerful interest groups.

The transaction costs of competitive tendering are relatively high. This is due to the essential requirement for competent and honest administrators and a well functioning legal framework - a scarce commodity in most PCPEs. This privatisation method will lead, at least in countries like Azerbaijan, to an insider privatisation. Contractual obligations could, however, ensure the initial stages of restructuring.

3.4.2 Employee stock ownership plans and management buy-outs

ESOPs are financing schemes to foster employee participation and are also used to organise leveraged employee buy-outs.⁷³ ESOPs originated in the mid-1970s in the US and different variants have been introduced in many other countries since.⁷⁴ Ellerman, Vahcic, and Petrin (1991: 292-295) recommend ESOPs for the privatisation process in PCPEs.

ESOPs can be financed either through (1) a stock bonus plan or (2) money bonus plan trusts; or (3) in case of leveraged ESOPs, credit from financial institutions (cf. Bogetic 1992: 91).⁷⁵ A combination of these means of finance is also possible. ESOPs provide for employees to receive securities according to their contributions. They are fully or partially paid out when employees retire, leave or under circumstances specified in the plan. ESOP-privatisations in PCPEs are considered as leveraged employee buy-outs (cf. Wieners 1994: 99).

⁷³ There is extensive literature on ESOPs. See for example, Bogetic (1992: 90-94), Hansmann (1990), Monks and Minow (1995: 253-257), Rosen (1990) and Vuylsteke (1988: 29-34).

⁷⁴ The largest ESOP sector is in the US. One tenth of the 10 000 enterprises with ESOP in the USA are 100 per cent employee-owned (cf. Hansmann 1990: 1752). Bogetic (1992: 91) summarises the goals of ESOP legislation in the US as follows:

(a) to broaden the ownership base of corporate stock, (b) to stimulate capital formation by providing more funds for corporate finance, and (c) to stimulate improvements in the performance of participating corporations.

⁷⁵ In case of a money purchase plan, contributions are paid according to a specific contribution schedule (e.g. ten per cent salary deduction per year). In a stock bonus plan the level of contribution is determined each year. The contributions are allocated to the accounts of individual participating employees.

If the trading of the securities is not only restricted to employees, the enterprises with ESOPs can evolve into ordinary joint-stock companies. However, a blockage period can be introduced, in order to avoid early dilution of the employee ownership.

Enterprises with ESOPs are not self-managed. They have a governance structure similar to that of a joint-stock-company, though supplementary participation in decision-making could be organised through, for example, establishment of committees, delegates of work groups or advisory councils. There is also the possibility of creating an extreme case of ESOP in form of a Mondragon co-operative, which is 100 per cent employee-owned and employee-managed (Bogetic 1992: 94).⁷⁶

In an MBO the managers receive the biggest stake in the enterprise. However, other employees can also own shares. The often only de jure separation of ownership and management is erased; enterprises are managed by their owner-managers. In PCPEs, leveraged MBOs mostly take place, financed usually through state banks, but also sometimes by private financial institutions.

In most PCPEs, most employee buy-outs and in particular MBOs have taken place or are planned in the privatisation of retail and other small service outlets (cf. Bogetic 1992: 97-100; Daviddi 1995: 13; Sondhof and Stahl 1992: 4-8).⁷⁷ ESOPs and MBOs are one outcome of competitive tendering and most advantages and disadvantages of a free transfer to the workforce and/or management, as discussed above, also apply. ESOPs/MBOs differ from free transfer methods in essentially three ways. (1) In ESOPs/MBOs a complex

⁷⁶ "Mondragon co-operative came into existence during the 1940s in the town of Mondragon, Spain, in the Basque region of Gupiszcoa, when Jose Maria Arizmendi, a local priest, started a small technical school for teaching basic industrial skills to local youth. In 1956 these students created the first Mondragon co-operative. Mondragon has since become a diversified industrial complex of more than 100 similarly organised firms, with more than 20,000 employees. Only two of these co-operatives ever went bankrupt, compared with bankruptcy rates for new firms of 80 percent and 50 percent in the United States and the United Kingdom, respectively." (Bogetic 1992: 94)

There is an extensive theoretical and empirical literature on Mondragon co-operatives. See for example, Bradley and Gelb (1982, 1983, 1987), Thomas (1982), Thomas and Logan (1982), and Whyte and Whyte (1988).

⁷⁷ For a detailed analysis of MBOs in the former GDR, see Kokalj and Hüfner (1994).

contract can be set up conditioning initial steps of restructuring, employment guarantees etc. (2) Administrative costs will be higher in ESOPs/MBOs, as negotiation, information and monitoring costs rise with a complex contract. However, costs will not be as high as with competitive tendering as there is a limited number of bidders (one for each enterprise). (3) The state receives some revenue from the privatisation in ESOPs/MBOs.

Thus, ESOPs and MBOs have relatively low transaction costs and offer significant advantages over other privatisation methods in terms of governance, restructuring and curbing of patronage networks.

3.4.3 Sale of shares through capital market operations and public offering

The conception of a stock exchange has a very powerful positive image in PCPEs. Stock exchanges are regarded as 'the ultimate symbol of capitalist maturity' (Frydman and Rapaczynski 1994: 60) and believed to be an effective device for exercising external control over corporate management. Sale of shares through capital market operations have so far taken place in Poland, most notably the case of Prochnik Joint Stock Company (cf. Dabrowski 1993a), and in Hungary where, in the case of Ibuz, shares were issued in parallel on the Budapest and Vienna stock exchanges (cf. Apathy 1993). The success is questionable so far.⁷⁸

Proponents of this privatisation method build their arguments on their confidence in the discipline imposed by the capital market, the market of corporate control and the market for managers. The enormous agency costs arising through the separation of ownership and control are assumed to be diminished through four interrelated mechanisms: (1) the capital market, (2) the market for

⁷⁸ According to Dabrowski's (1993a: 116) report on the case of Prochnik Joint Stock Company, the Warsaw Stock Exchange is characterised by thin trading and substantial volatility. Prochnik was first privatised via public offering of shares and later introduced to the stock exchange. Whilst the share price of Prochnik increased in the first week of trading by 12 per cent (exceeding the real buying price by almost 40 per cent if paid in bonds), it gradually decreased from then on. As a result it was suspended a few times.

corporate control, i.e. external take-over threads, (3) the manager-employment-market, and (4) creditor financial institutions.⁷⁹

The shortcomings of these mechanisms are well known and need not be rehearsed here in detail. In brief, there are four major criticisms: (1) the lack of competition on product markets significantly restricts share prices as performance-indicators; (2) the problem of 'shareholder collective action' weakens effective monitoring; (3) the adequacy of take-overs as a selection mechanism is also disputed (cf. Chang and Singh 1993: 54); and most importantly (4) the lack of sound capital markets in PCPEs makes stock exchanges as control mechanism over corporate management infeasible. The development of capital markets, including the establishment of an infrastructure of financial and legal institutions, is a long process which can take decades. The restructuring process in PCPEs cannot wait for years. Even if it would be possible to institute capital markets in PCPEs in a reasonable time, it is questionable whether the development of stock exchanges is desirable for industrial restructuring. First, Frydman and Rapaczynski (1994: 61) notes that stock markets feature high liquidity and thus easy exit. Rather than investors monitoring and sanctioning management they simply withdraw their capital.

Second, the insecurity of managerial positions, implied by the threat of hostile take-overs, encourages short-termism (cf. Frydman and Rapaczynski 1994: 61). Managers will be reluctant to restructure when their future is uncertain.

Third, the cultural preconceptions of owning shares is not about involvement and commitment in an enterprise. The short-term get-rich-quick philosophy is demonstrated by ridiculously high return promises of MMM in the

⁷⁹ The mechanisms and their shortcomings were already discussed in section 1.2.

Russian Federation (cf. Kagarlitsky 1995a: 105-114 and Kaser 1995: 46).⁸⁰ Rather than passive shareholding a participatory culture should be promoted. The immense restructuring requirements in PCPEs do not leave any space for short-termist speculative behaviour.

In public offerings, shares are not sold at a fluctuating price, as in a stock market infusion. They are offered either on a fixed price or on a tender basis (Vuylsteke 1988: 12).⁸¹ In case of oversubscription, some rationing device has to be used.⁸² In case offerings are underwritten, some underwriting capacity has to be established. In the setting of PCPEs with practically non-existent capital markets, the state would have to retain underwritten shares.

Vuylsteke (1988: 13) identifies four requirements for public offerings: (1) current or potential profitability of enterprise; (2) full availability of financial, management and other information concerning the enterprise; (3) sufficient domestic liquidity; (4) either developed capital markets or 'some structured mechanism (including a regulatory body) that can be made to function to reach, inform and attract (as well protect) the general investing public' (Vuylsteke 1988: 13). These requirements are rarely fulfilled in most of the larger enterprises in

⁸⁰ MMM, set up by Sergey Mavrodi, is one of the many Russian investment companies established since 1992. Kagarlitsky (1995a: 107) describes their operating system as follows:

The companies were operating on the pyramid principle, under which high returns were paid to existing investors out of funds contributed by new ones. Almost all the firms told tall stories about their investment projects, but speculating with their own and other people's securities remained the only type of activity that was bringing them profits. Most of these companies, including MMM, have since gone out of business. The director of the failed investment company MMM was partially successful in attributing the company's collapse to the government's attempt to prosecute him for blatant tax avoidance. MMM's fame spread throughout the FSU due to an aggressive television advertising campaign in soap opera format. The characters in these advertisements have entered popular consciousness all over the FSU. Even the four year old Azerbaijani god-child of the author knows all the characters.

⁸¹ The fixed priced route can lead to an oversubscription. In case of an offer by tender, 'the striking price represents the balance between tenders made at different prices and the number of shares available, with all those who have tendered above the striking price receiving shares' at that price (Vuylsteke 1988: 112). A variation would be to determine the price through an auction of an initial block of shares.

⁸² Vuylsteke (1988: 112) suggests as a rationing device to scale down the number of shares sold to each applying party in proportion to total applications.

PCPEs. First, most of the larger enterprises require substantial restructuring before profitability can be reached. Major restructuring is frequently not even in its initial stages.

Secondly, there are problems of valuation, as already discussed in section 3.3.2. It is almost impossible to obtain a full track record of past profitability upon which future expectations can be based. Moreover, the available historical data have little relevance because of the profoundly changing economic environment. An approximate valuation requires insider co-operation. It is unrealistic to expect co-operation without any significant benefits for insiders.

Third, scarce private savings limit potential investors to 'nouveau riche' and nomenklatura. As Kagarlitsky (1995a: 90-91) impressively demonstrates using Russian experience, there has to be great concern that a significant part of these groups only take interest in speculating and turning the enterprises into their 'objects of consumption'. Their consumer time preferences are short term and they have little incentive to initiate and supervise restructuring for prosperity in the uncertain future.

Fourth, capital markets are practically non-existent. Nor are there any structured mechanisms which could play this co-ordinating function. The MMM case in the Russian Federation is only one example which illustrates how desperately a functioning regulatory body is needed (cf. Kagarlitsky 1995a: 105-114).

Considering that the requirements of privatisation through capital markets or public offerings cannot be met, it hardly seems worthwhile to assess the transaction costs involved. However, to provide a full picture, in the following, the methods will be examined in the given framework.⁸³ First, the sole distribution-criterion is the price and in case of oversubscription in public offerings, rationing. The price an investor is prepared to pay fails to indicate the economic competence and the potential for further capital contributions. A workforce with a viable restructuring proposal might be outbid by members of the nouveau riche who

⁸³ Public offerings of shares has been partially used in the privatisation processes in Hungary and Poland (Daviddi 1995: 12). For a case study, see for example the example of the Prochnik Joint Stock Company in Poland (Dabrowski 1993).

might intend only the sale of the real estate and dismantling of the assets of the enterprise.

Second, as already indicated above, the administrative costs of a privatisation via stock market as well as via public offering are very high. A structured mechanism has to be established which implements the marketing and sale of the shares. A competent regulatory body has to be set up to ensure an adequate level of disclosure of performance information of enterprises, in order to safeguard against extreme financial risks of investors. Mutual funds and other investment trusts which might become intermediaries between shareholders and companies also have to be regulated in order to prevent cases like the MMM debacle in the Russian Federation (cf. Kagarlitsky 1995a: 110-114). This is particularly relevant for the trading of shares after the initial launch. The setting of prices evolves a far more precise valuation. If the prices are set too low, investors are attracted who are only interested in skimming the windfall profits and speculation might evolve. It is not desirable for the restructuring process that assets change hands quickly and frequently, giving initial purchasers large capital gains. Ideally, gains made by investors, should be reinvested in the enterprises themselves. In case of too high prices, no investors might be found at all.

Third, the intention behind public offerings is to attract a core investor who exercises control over management and initiates the restructuring process. Core investors might be found for small- and medium-sized enterprises. However, this is less realistic for large enterprises. Moreover, as mentioned before, if the price is set lower than the real liquidation value, short-termist opportunistic investors might be attracted, which impede the restructuring process rather than set it in motion. Due to the inability to accumulate private capital in the FSU legally and legitimately, most potential core investors have gained their savings through exploiting and subverting state assets and resources.⁸⁴ Thus, there is no tradition and expertise in long-term investment in restructuring projects. It is more likely that such investors are more interested in investments with returns faster than most of the enterprises requiring heavy restructuring can provide. For the majority of

⁸⁴ An exception is capital accumulation which legally took place in recent years in small private agricultural operations and small-scale trading.

the enterprises foreign capital is also unlikely to be forthcoming (Heitger, Schrader, and Bode 1992: 143-145). Except for some nostalgic patriotic investors from the exile community, foreigners in the FSU are mainly interested in resource extraction and monopolistic enterprises. In case of small investors, the more dispersed the ownership rights are, the more control remains strongly in insider hands. Managers might formally comply with the corporatisation legislation, i.e. holding board and shareholder meetings, but with little impact on the decisions affecting the operation of enterprises (cf. Webster et al. 1995a: 28-29). Depending on the stake held by investors of the *nomenklatura*, *nouveau riche*, and state institutions, old alliances might even be strengthened, and embark on new forms of rent-seeking behaviour.

Fourth, agency costs depend on the size and asset specificity of the enterprise. The larger the enterprise, the higher they can be expected to be due to asymmetric information between owners and managers.

Both the methods of public offerings and of the sale of shares through capital market operations are not likely to help to establish new effective corporate governance structures and launch restructuring. In case of fragmented ownership, insiders will remain in their control positions. Depending on the mix of investors, there is even the danger of strengthening old patronage networks and new forms of rent-seeking behaviour.

3.4.4 Public auction

Auctions are particularly recommended for selling petty assets, like retail outlets and workshops.⁸⁵ They also are an option for selling blocks of shares. There are several variants of auctions (cf. McAfee and McMillan 1987). The most common is the Dutch version, in which the auctioneer starts at a high price and gradually reduces the price until someone makes a bid or the floor reservation price is

⁸⁵ There is extensive theoretical and empirical literature on auctions. See, for example, Maskin and Riley (1985), Maskin (1992), McAfee and McMillan (1987), Milgrom and Weber (1985), and Riley and Samuelson (1981).

reached, in which case no sale occurs.⁸⁶ The reverse is known as English auction (cf. McAfee and McMillan 1987), starting from the floor reservation price. Brücker (1993: 69) stresses that the auction itself can assist in determining the price and that thus time-consuming valuation can be avoided. However, this assumes that truly competitive bidding occurs. For most assets in PCPEs this assumption is not realistic, due to a lack of investors. Thus a realistic floor reservation price has to be set.

The evaluation of public auctions is similar to that of a public offering of shares except for administrative costs. Auctions have lower administrative costs than public offerings of shares, as bigger units are sold and thus less buyers are involved. Moreover, because of the nature of auctions, there is no rationing necessary.

3.5 Divestment of user rights: Leasing

Divestment of user rights is recommended when full ownership rights cannot be transferred for political reasons or when potential buyers do not have sufficient funds at their disposal and credit is not available (cf. Vuylsteke 1988: 34-40). This mode of privatisation is more appropriate for sectors and enterprises which do not require major restructuring.

Leasing has negative connotations due to its use as a form of nomenklatura privatisation in the former USSR, most notably in the Russian Federation (cf. Bim, Jones, and Weisskopf 1993; 1994: 258-260; Radygin 1995: 11-12).⁸⁷ Lease-arrangements are not conducive to long-term rehabilitation and restructuring of enterprises, unless they include investment obligations by the lessee. Leasing involves high transaction costs and its success depends on the integrity of the authority responsible for leases, the lease-agreements themselves and their enforcement. First, multiple distribution criteria can be employed in selecting the

⁸⁶ Dutch auctions were used in the privatisation process in former Czechoslovakia (cf. Frydman et al. 1993a: 77-79).

⁸⁷ Between 1990 and 1991 20 000 lease enterprises emerged in the USSR as a means of escaping from control from above (Radygin 1995: 11-12). One form of lease-contract included the right to buy-out (ibid.: 12).

lessee, these include investment and maintenance and repair obligations, compensation for capital gains and expenditures, etc. Through such adequate criteria determined by the lease-contract the erosion of the capital stock can be limited.

Second, the administrative costs are relatively high. Like most sale methods it requires a developed and firm legal framework with speedy means of contract enforcement and competence of the authority dealing with lease-arrangements. Moreover, due to the degree of discretion this authority possesses, firm regulation and control have to be established. There is an inherent problem of asymmetric information between the lessee (insider) and the state authority. The lessee will not have the incentive to release the information required to determine the level of compensation payments. The problem of asymmetric information naturally rises with the complexity of the business to be leased out. This could be reduced, if the lessee would be selected by competitive tendering. However, if insider bidders can claim de facto property rights, attentive other bidders will hardly be forthcoming. A successful lease-arrangement can make a contribution towards administrative costs, through the compensation payments of the lessee.

Third, realignment costs occur, if a lessee either fails to meet his/her contractual obligations or subvert the lease (e.g. by asset stripping). However, they can be kept low if the leased enterprise is adequately monitored.

Fourth, provided a firm legal framework with effective means of contract enforcement is in place, the complex nature of the lease-contract can largely decide the future of an enterprise.

Fifth, economic competence and capital contributions can be insured through the multiple distribution criteria used in the selection of the lessee.

Sixth, lease-agreements will be not viable if de facto property rights held by insiders are not considered. The degree to which the lessee assumes the full commercial risk of the operation (i.e. hard budget constraints are introduced) depends on the lease-contract and the integrity of the authority dealing with the leases.

Lease-agreements are flexible and can accommodate specific conditions of enterprises, including restructuring plans. Their success depends heavily on the

institutional framework. Without a strong legal infrastructure, the fulfilment of the lessee's obligations cannot be safeguarded. Thus very complex lease-contracts are not feasible, because of the exorbitant transaction costs they would cause.

Concluding remarks

This chapter has tried to evaluate the potential level of transaction costs and the impact of alternative privatisation methods on both static and dynamic efficiency. The results are summarised in Table 3-4. The free transfer of enterprises to employees approach followed by ESOP/MBO, competitive tendering and leasing arrangements promise most success in the framework given. Voucher privatisation schemes and other free transfers to the public as well as privatisations through capital markets and auctions have additional drawbacks. Instead of developing responsible entrepreneurs and thus encouraging conditions for the development of sound corporate governance and restructuring, they create a culture of 'freeloaderdom'. Old and new entrepreneurs engage rather in short-termist speculative activities and the exploitation of loopholes in the legal framework. Moreover, in the absence of an appropriate regulatory framework and properly audited, reliable information about enterprises, these newly developing capital markets are prone to be subjected to manipulation and outright fraud. Such privatisation will lead to a long battle over the distribution of property rights out of which the nomenklatura is likely to emerge as winners. A lot of resources will be drawn out of the economy in the form of windfall incomes to the nouveau riche. Rather than reinvesting these funds in their unstable economies, which are also heavily burdened through political uncertainty, they can choose the way of capital flight.

Moreover, as the Russian example has already shown, ex ante expectations of an egalitarian share distribution and equal start opportunities for all, do not necessarily match the ex post outcome. This could cause deeper political dissatisfaction of the broad group of losers from privatisation and lead to further political destabilisation.

However, it has to be noted that the choice of the method of privatisation depends also on the kind of enterprise. As mentioned before factors like size ,

factor specificity and other enterprise and sector specific factors play a great role. Moreover, the applicability of a method can be different from country to country depending on whether the state is strong enough to carry through programmes irrespective of the interests of the nomenklatura.

Table 3-4: Evaluation of alternative privatisation methods

	Sale vs. give away	Distribution criteria	Administrative costs	Realignment costs	Contract type	Economic competence	Potential capital contributions	Insider control	Agency costs
Restitution	give away	pre-CPE owner, legal claim	high	high	standard	unknown	unknown	outsider control	depending on firm size
Free transfer to workforce a/o man.	give away	employed by enterprise	low	low	standard	very high	low	restricted insider control	low
Vouchers for share auction	give away	-	very high	low	standard	low	nil	unrestricted insider control	high
Shares in operating companies	give away	-	high	low	standard	low	nil	unrestricted insider control	high
Shares in investment trusts etc.	give away	-	high	low	standard	low	nil	unrestricted insider control	high
Competitive tendering	sale	multiple criteria	high	high	complex	high	high	dependent on distribution criteria	low
ESOP/MBO	sale	multiple criteria	medium	low	complex	very high	low	restricted insider control	low
Capital market operations and public offering	sale	price, rationing	very high	low	standard	low	low	unrestricted insider control	high
Public auction	sale	price	low	low	standard	unknown	unknown	unknown	depending on firm size
Leasing	non-sale	multiple criteria	medium	low	complex	very high	medium	restricted insider control	depending on firm size

PART TWO

4. The point of departure

Introduction

Part one set up a theoretical framework under which privatisation in PCPEs can be evaluated. It has established that privatisation can be understood as a means of building up a sound system of enterprise control and of initiating industrial restructuring. The success and effectiveness of this tool, however, are dependent on various factors, most eminently: (1) the evolution of institutional preconditions, i.e. the development of the political, legal, and financial framework and more fundamental institutions of a market environment; (2) the question of the power of the state, i.e. is it a strong state, with agenda-setting power, or a weak state, susceptible to counterproductive rent-seeking activities of insiders; (3) on proposed methods of privatisation; and (4) the process of contracting for property rights. By applying the theories of privatisation in PCPEs developed in the first part, the second part provides an account of the Azeri privatisation process and its likely effect on static and dynamic efficiency placing special emphasis on institutional preconditions.

Four sources of evidence were used: (1) documentation: administrative documents, laws, proposals, progress reports etc.; (2) archival records: statistics, organisational records, telephone and other listings, survey data, etc.; (3) personal interviews which were carried out in Azeri language (open-ended as well as in structured form);¹ and (4) direct observation and participant observation as a member of staff at Western University (Baku)^{2,3} The analysis is based on original

¹ On the design of such interviews, see Douglas (1984), Foddy (1993), McCracken (1988) and Neijens (1987).

² The author has been teaching economics and participated in research activities at Western University (Baku) in 1994.

³ Direct observations can often provide additional useful information. Yin (1994: 87) points out two examples:

(1) For instance, the condition of buildings or work spaces will indicate something about the climate or impoverishment of an organisation; similarly, the location or the furnishings of a respondent's office may be one indicator of the status of the respondent within an organisation.

Azeri documents and archival records collected (many of them not having been available to academia before), transcripts of almost 127 hours of interviews, and extensive fieldwork protocols of field visits carried out between December 1993 and February 1995.⁴

The research was started by identifying and interviewing key informants.⁵ Attempts were made to get the permission of 'gatekeepers' (Peil 1993: 73), where possible. However, co-operation with officials in single institutions was not forthcoming merely on command from their superiors; it was necessary first to gain their confidence and interest in one's project, which was often very time-consuming.⁶ Data collection in Azerbaijan was mainly impeded by three factors.⁷ First, Azeri is the official language since independence. Thus, all official documents are in Azeri. However, as this is a recent development, quite a number of members of the elite are not very familiar with many Azeri technical terms. Moreover, often direct translations of technical terms from English into Azeri or Russian can distort the meaning. Hence, special care was required to achieve a conceptual equivalence of terms in the interviews because of the many languages involved.⁸

Second, the inherited Soviet statistical system might often impress western statisticians because of its preference for complete population over sample surveys. However, cautious interpretation is necessary because of serious data and reporting problems. The national accounting system in Azerbaijan is in the process of being converted to the UN System of National Accounts. In the

(2) Very important in a PCPEs context is also the assessment of the respondent's and his/her family's clothes, car, and private house, as this reflects his/her status and corruption. For instance, if somebody who is on a salary of the equivalent of US\$20 wears a Rolex watch and his wife a Hermès scarf, it is quite evident that he cannot have earned the money to buy such luxurious items by honest means. On direct and participant observation, see Silverman (1993: 30-58), Stacey (1969: 50-69), and Yin (1994: 86-87).

⁴ The overall research design has drawn upon Hamel (1993) and Yin (1981 a and b; 1994).

⁵ On the merits of key informants, see Stacey (1969: 47-48).

⁶ On the politics and ethics of field research, see Warwick (1993b).

⁷ See also Miles (1983) on difficulties of qualitative data interpretation and fieldwork.

⁸ The problem of language difficulties, especially in multi-ethnic countries is pointed out by Peil (1993: 86); Bulmer (1993a: 11-12) and Bulmer and Warwick (1993: 152-153).

meantime and for historical data, there is still uncertainty regarding various methodological approaches and the quality of many macroeconomic indicators. A detailed discussion of data and reporting problems of official Azeri statistics is, however, beyond the scope of this work.⁹ Even seemingly 'straightforward' data were not always available in the form desired and had to be constructed in conjunction with a variety of officials.

Finally, officials were very secretive and often contradictory. It required sensitivity and caution to interpret their accounts of developments. This is to a certain extent a relict from old Soviet times, and is a necessity in a social and economic environment dominated by 'informal' rules and regulations.¹⁰ Considering the violent social disintegration, political turmoil, and general institutional hiatus in many PCPEs, research conditions are, of course, tough.¹¹

This chapter is concerned with the institutional background of privatisation in Azerbaijan. It tries to identify the new environment in which enterprises find themselves and their response to the extensive changes occurring. After presenting the political setting in which privatisation policy unfolds, the economic environment is analysed. Sections three and four are concerned with the legal and financial framework of Azerbaijan. The final section raises the sensitive issue of the power of the state, which is vital for the outcome of any privatisation policy.

Most of the information of the following chapter is based, if not otherwise stated, on the author's fieldwork and transcripts of interviews with the management and employees of plants, and various institutions.

⁹ For a more detailed discussion of the problems with statistics of PCPEs and particularly the FSU, see Blades (1991), CCEET (1992, 1993c), IMF et al. (1991: 133-169), and Trembl (1989).

¹⁰ Readers who are unfamiliar with the political environment of the FSU, and especially the Transcaucasus, will have difficulty understanding or appreciating secrecy, and the generally complex political and economic relationships and intricate patterns of interaction between these officials. The political environment differs sharply from those in the West.

¹¹ The author could provide material for many novels and scripts of feature films from her experiences in Azerbaijan.

4.1 The political setting

The nature and stability of the political system and the general political setting are major determinants of the evolution of the institutional preconditions of economic reform. These political determinants vary in the different PCPEs and, thus, have to be considered in each analysis of the transition process in any one country. In the FSU the political situation has the added factor of the disintegration and emergence of independent states.¹² These state building processes have been overshadowed by the release of ethnic tensions which had been often a direct consequence of cruel ethnic policies of the Stalin period and which had been suppressed in the meantime. At the same time these ethnic tensions were often used or even instigated by Russia to retain control in the newly independent republics under neo-colonial terms. Russia's desire to retain major influence over oil-rich Azerbaijan with its strategic location at the Caspian Sea has left its traces. It can be also seen in this very context that key players in the Azeri political arena who have been charged with treason have found refuge in Moscow.¹³ So far Azerbaijan has been able to stand up to Russia's demands; it has remained the only former Soviet republic (outside the Baltic States) with no Russian troops on its territory. The following analysis of the political setting can only be brief as a fuller account would be beyond the scope of this work.¹⁴

The political situation in Azerbaijan in the four years of its independence has been dominated by internal power struggles, decay of the state apparatus, and the Nagorno-Karabagh conflict. Between 1991 and 1995, there have been six

¹² See table 5-2 for dates of independence of the former Soviet republics.

¹³ This is the case for the former President Ayaz Mutalibov, the former Defence Minister Rahim Gaziev, and the former Prime Minister Surat Husseinov. See the corresponding footnotes of Table 5-1 for their profile.

¹⁴ For a good analysis of the historical development of Azerbaijan up to 1990, see Altstadt (1992). For more recent developments, see Aves (1993), Auch (1992), Fuller (1994), Götz and Halbach (1992), Grobe-Hagel (1992), and Hunter (1993). Goltz (1994) gives a personal account of the years 1991-1993 out of his perspective as a journalist. Goltz has spent almost this entire period in Azerbaijan. He speaks all the relevant languages and has been one of the only journalists who has been on all front-lines and made many direct observations of both the political developments and the war. Despite his non-scholarly approach he can be seen as an authority on the developments in Azerbaijan over this period.

acting presidents and several attempted coups. When in mid-1994 a cease-fire agreement was reached, the country had to cope with 25% of its territory being under Armenian occupation and with one million refugees and displaced persons (15% of the population). Table 5-1 gives a compact chronology of selected important political events and profiles of key political figures.

A key obstacle to effective institution building and political stability has been the failure to establish a legitimate legislative body which could have adopted a new constitution which would fundamentally re-distribute power and thus open the way for the restructuring of the whole political framework and development of an appropriate legal framework. Until almost 1996 Azerbaijan did not hold parliamentary elections or adopt a new constitution. The old constitution of 1978 supplemented by the Declaration of Independence serves as the country's basic law. After the declaration of independence the Parliament of Azerbaijan introduced a presidential form of government. This was in fact done through renaming the General Secretary of the local Communist Party as 'President' and turning the General Secretariat, or Aparat, into the Presidential Aparat, the de facto executive branch of government.¹⁵ The parallel structure to the Aparat, the Council of Ministries took the role of a Cabinet. Previously it was already de facto a redundant institution in the FSU, as it only duplicated the functions already undertaken by the Aparat and served merely as the training centre for the party structures and no doubt patronage networks.¹⁶ Now the cabinet is headed by the Prime Minister with his apparatus. The 'Ali Soviet', in Russian 'Verkhovnyi Sovyet', the local equivalent of the Supreme Soviet,¹⁷ with its 360 members acts in the capacity of parliament and hence as legislative body.¹⁸ The 360 members were installed in pre-independence days and consist mainly of captains of industry and

¹⁵ The general Secretariat of the local CP in the old Soviet days took and implemented the orders from the Politburo in the Kremlin.

¹⁶ See Figure 4-1 for the structure of the Council of Ministries.

¹⁷ For convenience the 'Ali Soviet' is referred to as the Supreme Soviet or parliament as it took over the role of the latter after independence.

¹⁸ It is important to note that in the FSU, de facto both the Supreme Soviet and the local legislature had no power. They only met a few times per year to pro forma adopt legislation. Thus the new parliaments have no experience and tradition in genuine legislative procedures.

local executive leaders (i.e. mayors and governors of the provinces). It is thus heavily biased towards "insider" interests. In early 1992 President Mutalibov, under pressure from the Azerbaijan Popular Front (AzPF),¹⁹ agreed to the formation of a 50 member National Assembly, the Milli Mejlis, consisting of members of the previous Ali Soviet. This was an effort to give the parliamentary opposition a greater weight. However, in times of crisis and important decisions, the whole parliament was gathered, which led to confusions and uncertainties over the legal status of the decisions made. Due to the Soviet legacies the separation of power between legislative and executive branches of government is blurred. All important decisions are taken both by the Presidential Apparatus and by the Council of Ministers. The Presidential Apparatus also has primary responsibility for drafting new legislation. In fact all important policy decisions are implemented via presidential decree. The government of Azerbaijan is affected by continuing constitutional uncertainties.

The internal power struggles have left the dominance of the old nomenklatura unchallenged and stalled any attempt at institutional change. They have caused political apathy and wide disillusionment in the population and

¹⁹ The AzPF was a broad nationalist movement with a wide spectrum of supporters which grew particularly through the Karabagh conflict. Fuller (1994: 3) summarises:

This perceived threat to Azerbaijan's territorial integrity served as the catalyst for the awakening of a sense of national identity, and for the creation in early 1989 of the Azerbaijan Popular Front (AzPF) by a handful of intellectuals, among whom the 54-year-old oriental historian Abulfaz Elchibey was elected chairman of the Front. Originally conceived as a movement to support CPSU General Secretary Mikhail Gorbachev's much vaunted policies of glasnost and perestroika, the Front's programme professed its commitment to 'humanism, democracy, pluralism, internationalism and human rights', and cited as its aims the creation of a sovereign, constitutionally governed secular Azeri state within the USSR, with political and economic sovereignty.

There were many different fractions within the movement and, accordingly, many splits. As with many of these movements, the loose gathering of different interests later led to its downfall. However, the AzPF was the dominant opposition force with nation-wide structures and symbolised to many hope for the future. Elchibey's short presidency and its aftermath - with all its confirmed and alleged corruption and collective skimming and squandering of the nation's resources - led to a deep and paralytic resignation of large parts of the population. An often occurring remark uttered to the author was 'After all they were no better than the others' meaning the nomenklatura and conservative forces, under whichever facade they happen to appear.

stimulated short-term thinking as the general view of the future is pessimistic. Virtually a mass exodus has taken place of large parts of the Jewish community, Russians, and Azeri academics, other professionals and nouveau riche.²⁰ This again is not a fruitful breeding ground for economic reconstruction. Open political conflicts have cooled down under the presidency of Heydar Aliev,²¹ the former communist party leader of Azerbaijan (1969-1982), subsequent member of the Politburo²² in Moscow (1982-1987) and chairman of the Nakhichevan parliament (1991-1993), who poses now as a Muslim, democrat and nationalist.

As mentioned above, the last years have witnessed a decay of the state apparatus with far-reaching repercussions for the economy. Virtually all parts of the bureaucracy, including the prosecution services and the police are engaged in informal income generation, i.e. corruption. Hospitals treat patients only against 'informal payments'. Ambulance drivers collect the dead only against payment.²³ In Universities weak students can pass through payments. Payments are even common in primary schools. In order to get a position even as primary school teacher payment is necessary. Informal payments are required for the repair of the

²⁰ Emigration was definitely an issue on which the author was constantly consulted.

²¹ Heydar Aliev was born 1923 in Nakhjivan and is no doubt a living legend fed by uncountable rumours about his brilliant memory and mastery of political manoeuvres. Before he became communist party leader in Azerbaijan he had climbed the career ladder in the security organs (KGB and its forerunner NKVD) up to chairman of the KGB in Azerbaijan in 1965. In his long time (14 years) as First Secretary he was renowned for clamping down on existing corruption, mafia circles and patronage networks; however, at the same time establishing his own patronage networks in order to reinforce his own power. He is often described as being more obsessed with personal power than with wealth. His political career in the Central Politburo was ended when Gorbachev succeeded in gradually forcing him into retirement, and subsequently led to a heavy defamation campaign in which he was accused of corruption and abuse of power. In the summer of 1990 he returned to Nakhichevan, where he was elected chairman of the local Supreme Soviet. When he took over power in June 1993 there were initially rumours that he had been involved in the coup of Husseinov and that he was 'Moscow's man'. However, in the year to follow, it became quite apparent that Aliev was a man of his own mission, who carefully knew how to manoeuvre and achieve some political stability. This was even acknowledged by his severest critics.

²² The Politburo consisted of ten member from different republican communist parties and was the highest organ of the Soviet Union. His rise into the Politburo was an absolute sensation in Turkey, as he was seen as the first and only 'Turk' in the highest organ of power in the FSU.

²³ In January 1995 it cost the equivalent of US\$20, i.e. almost 20 times the minimum wage, to have a deceased taken to the morgue.

telephone line. Payments can reduce taxes. Export licences can be obtained against payment. And the list could be endlessly extended. The situation is widely accepted and occasional protests seem to be only uttered if a bribe above the 'going rate' is demanded. Small- and medium- sized enterprises, whose development is heavily propagated by World Bank and EBRD, particularly suffer from lack of influence. As most of these little entrepreneurs lack the right connections into the higher political structure, they are exposed to pressures of police, tax inspectorate, and prosecution services. Often, as in the case of export licences, procedures are complicated as potential gains from bribes are highly contested. CMA, Customs Committee, Ministry of Trade, Ministry of Material Resources, the International Relations Committee, and the Ministry of Foreign Economic Relations are all involved in the export contracts and licence business.²⁴

The Karabagh war which even in its heights was hardly noticeable in the capital Baku, has also to be seen in the context of internal power struggles. Many Azeris, as also do foreign observers like Goltz (1994), suggest that the war could have been fought more effectively if its continuation had not been so beneficial to large parts of the establishment. Besides a welcome distraction from ongoing redistribution of national wealth, it created a major source of income. First, money could be diverted from secret funds assigned for defence purposes. There are no figures available. However the sums estimated are enormous. Second, bribes could be expected from arms dealers to officials authorised with the purchase of arms and other equipment. Third, the Ministry of Defence and the police could generate bribes from draft dodgers and deserters. It is common knowledge that the

²⁴ In order to alleviate economic crime, in the form of unrecorded and illegal exports, export contracts had to be approved by the Ministry of Foreign Economic Relations and were controlled by the International Relations Committee before goods could be cleared by Customs. Additionally, state orders in line with bilateral trade agreements and required export licences were managed by the Ministry of Trade, Ministry of Material Resources, and the Ministry of Foreign Economic Relations. Until March 1995 there have been export licence requirements for all 'strategic' goods, which constitute almost 80% of all exports. There are 36 strategic goods, e.g. oil and petroleum products, cotton and cotton by-products, sulphanol, synthetic rubber, ferrous and non-ferrous metal ore and products, aluminium and aluminium scrap, ceramic and other construction materials etc. Licences were issued by the Ministry of Foreign Economic Relations up to the quotas set for each product category by the Ministry of Economy. There were many irregularities reported in the issuing of licences.

war was only fought by those without adequate resources and by very few patriots. Fourth, there was the business of humanitarian aid. Medical, food, and supplies aid could be diverted to the domestic market. Markets in Baku and other towns and villages were full with aid products.²⁵ And there were all the relatively well paid jobs as drivers, translators, cooks, office administrators, and cleaners with the many aid organisations, each of which established their own service apparatus.

²⁵ Goltz (1994: 454) describes the scandal of the aid request, personally presented by the former Premier and future Foreign Minister Hasan Hasanov in New York to the UN Secretary General Butros Ghali, for 40,000 electric irons for refugee tent camps (i.e. US\$500,000 worth of merchandise for the Iranian, Turkish and FSU domestic markets).

Table 4-1: Chronology of selected important political events

<i>Date</i>	<i>Events</i>
Aug. 1987	Petition of the Armenian republic to annex the Nagorno-Karabagh Autonomous Oblast (NKAO) which is part of the Azerbaijan SSR since 1923 (Altstadt 1992: 195; Grobe-Hagel 1992: 48-50). ²⁶
Feb. 1988	First waves of anti-Azeri demonstrations in Erevan and NKAO; ²⁷ Azeris begin to flee from Armenia and NKAO. ²⁸
Mar. 1988	Anti-Armenian riots in Sumgait. ²⁹ (32 casualties of which 26 were Armenians.) Armenians in Azerbaijan begin to flee to Armenia and abroad. ³⁰ Ongoing conflict in the NKAO region. Formation of the AzPF around Elchibey ³¹ with nation-wide structures.

²⁶ Altstadt (1992: 125-127) provides a compact chronicle of the development of the NKAO. Many interviewees and Goltz (1994: 8) presented the noteworthy view that Stalin set up the association of the NKAO with Azerbaijan purposely in order to have a long-term lever to 'distract, divide and rule'. See also, SWB 8 Mar. 1988.

²⁷ TAS 23-28 Feb. 1988, and SWB 24-29 Feb. 1988.

²⁸ SWB 3-4 Mar. 1988. According to Altstadt (1992: 197), beginning 1988, there have been 200,000 Azeris in Armenia.

²⁹ SWB 1-8 Mar 1988, AP 4 Mar. 1988, and TAS 3-4 Mar. 1988. The population of the industrial town Sumgait close to Baku consists mainly of Azeri refugees who had to flee from their villages in Armenia in the 1940s (cf. Altstadt 1992: 197).

³⁰ Goltz (1994: 7-8) summarises the repercussions the Nagorno-Karabagh conflict had in terms of refugees and displaced people as follows:

But theoretical discussion aside, one is left with the facts on the ground: as a direct result of Armenian aggression, the number of Azeris who have fled their homes now [1994] exceeds one million-something like 15% of the population as a whole.

Nor were all the victims of Armenian irredentism Azeris. In 1988, there were around 500,000 ethnic Armenian citizens of Azerbaijan. The vast majority lived in Baku; the minority, around 150,000, lived in [...] NKAO. By 1994, there were less than 10,000 Armenians in Baku (most spouses in mixed marriages) and 150,000 Armenians in Karabakh. The 350,000 from Baku had been sacrificed on the altar of nationalism, providing the rationale for Karabakh to secede from Azerbaijan and attach itself to Armenia-along with a good-sized chunk of Azeri territory outside Karabakh that had been ethnically cleansed for ease of incorporation.

³¹ Abulfaz Aliiev alias Elchibey (i.e. 'emissary', it is his adopted name) was born in 1938 and is a native Nakhjivani (like Heydar Aliiev; however, they are not knowingly relatives. Aliiev is a very common surname in Azerbaijan. It is the russified version of Alizade). As orientalist (like many of Heydar Aliievs kinsmen) he worked as lecturer at the Orientalism faculty at Baku State University after his return from Egypt, where he had worked as translator at the Soviet-funded Aswan Dam project. His nationalist and Pan-Turkist tendencies (he was for the promotion of the Azeri language at the height of the Russification campaign pushed by the then CP chief Heydar Aliiev in the Breshniev era) brought him close to two years in prison. He became leader of the AzPF. Many Azeris, the author spoke to, suggest that he was abused as a figurehead. He became president in

Aug. 1989	Strikes in Baku to press for control over the disputed territory of Nagorno-Karabakh. ³²
Jan. 1990	"Black January": bloody communal conflict during the weekend of 13-14 January 1990 and massive Soviet Army intervention on 20 January 1990. Altstadt (1992: 213-219) presents evidence for the view that Moscow had staged the conflict in order to path the way for sending troops to Baku. ³³ There is a death toll of up to 150 (Fuller 1994: 4). Ayaz Nijat ogly Mutalibov is installed as new First Secretary of the Azeri CP. ³⁴
19-21 Aug. 1991	Attempted coup by conservative officials while Gorbachev is out of Moscow. ³⁵
20 Aug. 1991	Declaration of Independence of Azerbaijan.
9 Sept. 1991	Mutalibov is elected in the presidential polls as CP candidate. The election is boycotted by the democratic opposition (Goltz: 1994: 62). The CP of Azerbaijan is dissolved and the Central Committee building becomes de facto the presidency.
8 Dec. 1991	Russian Federation, Ukraine and Byelarus formed CIS, stating that the Soviet Union ceases to exist.
Late Feb. 1992	Khodzhalı Massacre ³⁶ Mutalibov is made responsible for severe negligence, because of lack of support from Baku and his attitude towards the use of Ex-Soviet troops and is forced to resign (Goltz 1994: 185-207). ³⁷ Yagub Mamedov is appointed Azerbaijan's acting president by the Supreme Soviet. ³⁸ However, the 'power ministries' were given to the 'opposition', i.e. defence (Rahim

1992, but was already forced to resign one year later and went into exile Nakhjivan. In the aftermath, he was accused of incompetence and weakness. In long televised debates with a show-trial character, from KGB agent to alcoholic, there is hardly any name left he was not called. However, it is noteworthy, that contrary to many of his companions and supporters who accumulated significant illicit wealth in this short era and who were not touched as badly, neither he nor his family gained any personal wealth out of his political activities.

³² SWB 22-24 Aug. 1988, TAS 21-23 Aug. 1988, and AP 21-23 Aug. 1988.

³³ This is the view of all the Azeris the Author has talked to. See also, AP 14-25 Jan 1990, SWP 14-24 Jan. 1990, and TAS 14-25 Jan. 1990.

³⁴ Mutalibov is generally regarded as the representative of the conservative forces within the CP. He is widely maligned for his complicity in the events around the 'Black January' and regarded as 'Moscow's agent' (cf. Goltz 1994: 76).

³⁵ KEE 01 Aug. 1992.

³⁶ In the little town bordering Karabakh around 1000 men, women and children were brutally slaughtered by Armenians backed by the 366th Ex-Soviet regiment (cf. Goltz 1994: 173-188). The government is accused of severe negligence because of total lack of support from Baku. See, RTN 1-2 Mar. 1992, and SWB 5 and 9 Mar 1992.

³⁷ See also, RTN 6 Mar. 1992, SWB 9 Mar. 1992 and TAS 9 Mar. 1992.

³⁸ See SWB 9 Mar. 1992. Yagub Mamedov was the former rector of the Baku Medical Institute. He was often nicknamed 'Dollar Yagub' as it was alleged that he took bribes from students. The Institute is renowned as one of the most 'profitable' in terms of bribes. However, there are surely very few in the establishment of Azerbaijan who would not deserve the prefix 'Dollar'. Like Mutalibov, he was a representative of the old guard.

May 1992	Gaziev) ³⁹ internal affairs (Tahir Aliev). Shusha, the last town held by Azeris in Karabakh, falls almost without fight under Rahim Gaziev as defence minister. ⁴⁰ Mutalibov tries a comeback but is defeated under AzPF pressure. ⁴¹ The 1957 born Isa Yunis oglu Gambar ⁴² becomes acting president for three weeks (Goltz 1994: 253-270).
7 June 1992	Elchibey is elected president in the presidential polls. ⁴³ His presidency lasts only for one year and is overshadowed with corruption scandals, economic decline, and several military defeats. ⁴⁴

³⁹ Rahim Gaziev, who is a man of many faces like so many of the political establishment, was AzPF supporter, remained in office till he was dismissed over corruption scandals on 8 February 1993 under the Elchibey government. He attempted to take over the television station in Baku. Goltz (1994: 206) gives the following characterisation:

[...] his ministry was marked by more corruption, defeat and defensive, paranoid bluster than one could imagine possible-so much so that in retrospect his selection as Defence Minister seems almost to have been part of a plan to destroy the country.

He was sentenced to jail under Heydar Aliev on charges of treason and went like Husseinov and Mutalibov into exile in Moscow.

⁴⁰ RTN 8 - 11 May 1992, SWB 10 -13 May 1992, and TAS 10 May 1992.

⁴¹ RTN 14 May 1992.

⁴² Isa Yunis oglu Gambar originated from Baku and had previously worked at the Oriental Institute of Azerbaijan. He was a protégé of Elchibey and one of the founders of the AzPF.

⁴³ RTN 6-10 June 1994, SWB 6-11 June 1994, and TAS 8 and 9 June 1994.

⁴⁴ Fuller (1994: 8) summarises the reasons for the fall of the AzPF and Elchibey as follows:

First, AzPF members were appointed to leading posts on the basis of their impeccable ideological credentials rather than competence or integrity, and many subsequently flaunted their illicitly acquired wealth.

Second, the inefficiency and corruption of leading officials compounded the process of demonstrations. This was accelerated when the Elchibey leadership broke off existing ties with Russia, Azerbaijan's most important trading partner, in 1992. Little was done to mitigate the rapid impoverishment of much of the population.

The final, and most crucial, influence was the dismal performance of the Azeri armed forces of large swathes of Azeri-populated territory in April 1993.

June 1993	Surat Husseinov ⁴⁵ instigates a coup against the Elchibey government from his base in Ganje. Heydar Aliev , was able to use the hour of confusion for his comeback. In Elchibey's absence he was voted 'acting president' by the Supreme Soviet and elected president in October 1993 in the new presidential polls.
Mid 1994	Cease-fire was negotiated. However, 20% of Azerbaijan remained under Armenian occupation. Almost 1 million people (13% of the population) have become refugees or displaced persons. Since 1988, according to official sources 20,000 Azeris have been killed and 4,400 have been taken prisoner or hostage, with many others being wounded and huge areas devastated.
October 1994	Prime Minister Surat Husseinov flees to Moscow after attempted coup could be defeated.

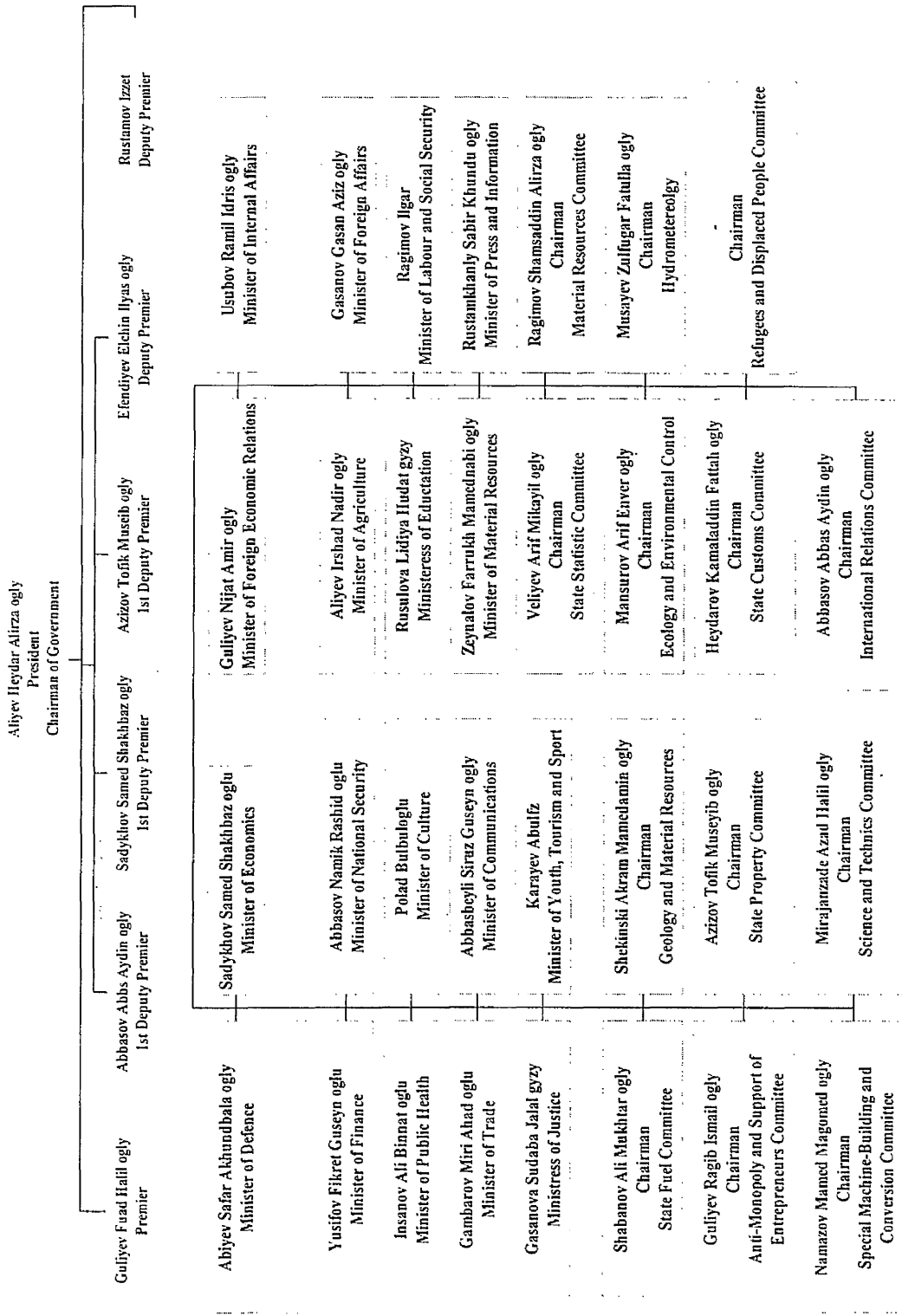
⁴⁵ Born in 1959, Surat Husseinov is a fast riser amongst the new generation of politicians, and being native from Ganje, he was not a natural kinsman of Heydar Aliev (Ganje and Nakhichevanis are rivals). He is said to have acquired quite significant financial resources through his position as captain of the wool industry and his alleged mafia-connections and used these resources to finance his private army and build himself up as a warlord. As recognition for his military efforts in the war he was appointed deputy prime minister under Elchibey. However, he was dismissed in disgrace in February 1993, when rumours of his planning a coup against the government became public. According to Golz (1994: 363), as revenge for his dismissal, he pulled his brigade away from the frontier along with most of the heavy equipment in the army. After this attempted coup against Elchibey, Husseinov was made prime minister by Heydar Aliev in an effort by the latter to absorb opposition he was too weak to defeat. Husseinov fled to Moscow after an attempted coup in October 1994.

Table 4-2: Dates of declarations of independence of former Union republics

Republic	Date
Armenia	Aug. 23 1991
AZERBAIJAN	Aug. 30 1991
Belarus	Aug. 24 1991
Estonia	Aug.20 1991
Georgia	April 9 1991
Kazakhstan	Dec. 16 1991
Kirgizstan	Aug.31 1991
Latvia	Aug. 20 1991
Lithuania	March 11 1990
Moldova	Aug. 27 1991
Tajikistan	Sept. 9 1991
Turkmenistan	Oct. 27 1991
Ukraine	Aug. 24 1991
Uzbekistan	Aug. 31 1991

Source: KEE 01 Aug. 1992

Figure 4-1: The Council of Ministries in Azerbaijan (January 1995)



Source: CMA

4.2 *The economic environment*

4.2.1 A brief overview of the Azeri economic performance

Since the late 1980s, the Azeri economy has experienced a severe slump in production and demand due to multiple external and internal shocks.⁴⁶ First, the escalation of the conflict over the Nagorno-Karabakh region, as described above, caused serious damage to the economy.

Second, the break up of the Soviet Union led to the abandonment of central planning and co-ordination and severe disruptions of inter-republican relations. Failures in central planning and the intention to keep the republics of the FSU interdependent in order to preserve the union, led to extreme degrees of specialisation of production and a wide geographical distribution of productive capacity within the FSU.⁴⁷ As transport costs were neglected, raw materials and intermediary goods were lugged from the other end of the SU rather than facilitating local content production. Many enterprises received their entire inputs from other republics and experienced severe supply bottlenecks when cut off from the Soviet economy. The attempt was made to alleviate trade problems by maintaining centrally planned trade relationships through a network of bilateral trade arrangements with other FSU countries.⁴⁸ The latter specify trade volumes

⁴⁶ For a more comprehensive report of the economic developments in Azerbaijan in recent years, see (IMF 1992 - 1995) and World Bank (1993).

⁴⁷ The degree of specialisation is also reflected in share of exports and imports of GDP. During 1987-90 exports and imports were averaging 46 percent and 37 percent of GDP respectively (IMF 1992: 3).

⁴⁸ Because of serious data and reporting problems, trade statistics are not discussed here in detail. There are no detailed trade data for Azerbaijan available for the period before 1987. Data could be only derived through the material supply statistics or even only from the reports of the state material supply enterprises or material supply subdivisions of enterprises. Until 1992 the ASSC reported export and import data in domestic prices, i.e. prices of the end-users, including subsidies, taxes, and freight charges. For 1987-1990 there is an All-Union series available for 'trade in roubles at world market prices' in which domestic prices are adjusted. From 1992 non-FSU data have been reported in US\$. It is questionable whether FSU trade figures can be revalued according to the dollar prices implicit in non-FSU countries, as commodity compositions of these two are very different and there is a lack of detailed volume data. Until 1994 trade data were reported

and prices.⁴⁹ Due to difficulties in interbank settlements and shortage of hard currency and roubles, these trade arrangements were in practice conducted on a barter basis. However, trade agreements more often became invalidated, as suppliers pushed towards world market prices and, increasingly, in order to comply with these agreements, state orders could not be fulfilled. Bilateral trade agreements were almost completely dropped at the beginning of 1995. Due to severe supply bottlenecks enterprises increasingly negotiated directly with their suppliers. Supplies were also obstructed through conflicts in Georgia beginning in 1994, and the closing of the northern trade route, in late 1994, due to the conflict in Chechnya. This also added to transportation costs as alternative routes had to be taken. The lack of maintenance and investment in infrastructure, i.e. mainly railroads and the Caspian Sea fleet, created further bottlenecks.⁵⁰ On the whole, the adoption of world market prices for raw materials and intermediary goods and the adjustments of costs for transport and energy had an immense negative shock impact on Azeri producers.

Third, there have been changes in domestic relative prices due to price liberalisation and the ending of most subsidies⁵¹ both to producers and consumers and the increase in taxes and 'informal duties' as discussed above. In January 1992, almost 80% of all producer and consumer prices were liberalised, further price liberalisations took place in late 1992 and 1993, leaving only bread, energy⁵² and public utilities (especially housing and transport) under price control. In

on the basis of enterprise surveys, and then on the basis of customs data, which should be more reliable. The categorisations of goods also slightly changed making comparisons between the years difficult. Trade data exclude re-exports, unrecorded imports and exports, which are estimated as quite significant for the years after 1991, and humanitarian imports. Re-exports consist mainly of products from other republics of the FSU destined for Iran. Unrecorded imports and exports include illegal trade through smuggling and under-invoicing and over-invoicing, imports of the large foreign investment projects and the oil consortium investments which have a duty exempt status, and military goods.

⁴⁹ Prices in trade agreements were well under the world market level.

⁵⁰ The most important means of transport have been rail and the Caspian sea fleet.

⁵¹ Although direct subsidies might have been curtailed or terminated, enterprises were still able to obtain credits at negative real interest rates as discussed below.

⁵² Until 1995 energy prices were at 25% of the world market level. Prices of petrol and other oil products rose in early 1995 with the intention to raise them to world market levels.

October 1991 a new tax system replaced the old Soviet system.⁵³ The newly established State Tax Inspectorate is responsible for tax administration and involved in the tax reforms.

Fourth, industry was abruptly exposed to aggressive competition by foreign markets, without any preparation- a bumpy if not crash landing. Domestic markets for food, pharmaceuticals, consumer durables, construction materials and textiles are dominated by foreign imports.⁵⁴ As discussed below, industrial restructuring towards an output structure which meets the new demand patterns and competitive environment has not yet taken place. Even slight adjustments in the marketing and distribution of goods has not even begun. The quality standards of many locally produced goods, like air conditioners and refrigerators, might be acceptable to consumers. However due to failures in distribution it is difficult to find them.⁵⁵ Locally produced tea has reportedly rotted in warehouses, whilst the whole market, even in tea producing areas, was swamped by Turkish and Iranian tea.

Fifth, the capital stock of industry has deteriorated. This is due to reported lack of investments and maintenance. However, it is impossible to quantify the decline of investment as no reliable disaggregated data are available. Figure 4-2 indicates the low investment for 1991 and for 1992 and relatively high levels of investment, when compared with the OECD average of 20.6 percent of GDP in 1994, in the rest of the period. These high measured investment levels are neither

⁵³ A value added tax was introduced to replace the old turnover and sales taxes, and a progressive income tax was adopted along with an excise tax, a new enterprise profit tax, a car ownership tax, and royalties for petroleum production. Export and import taxes are under constant review. Relevant laws were adopted but not implemented until 1995.

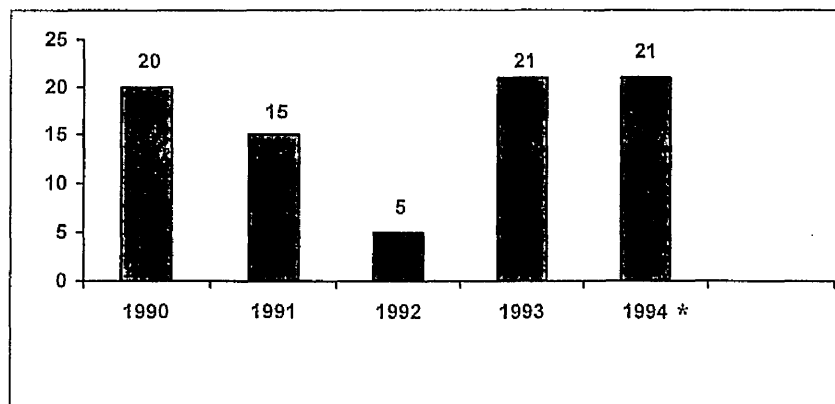
⁵⁴ The author, who has lived and worked in Azerbaijan and travelled extensively within the country was often even unable to find Azeri substitutes for imported goods. Again, as a significant volume of imported goods remains unrecorded in official trade statistics, more detailed market research would have to be carried out to quantify the market share of different foreign products in comparison to their Azeri substitutes. The IMF (1995: 6 and 28) confirms the dominance of foreign export goods, particularly in consumer durables.

⁵⁵ The trademarks of local products are often underestimated by foreign consultants. For instance, consumers have sometimes waited for years to acquire a 'Bakconditionar', the locally produced air conditioner, whose producer is still a monopoly within the FSU. Thus these air conditioners are highly valued.

reflected in economic growth nor in the information gained from interviews in enterprises, ministries, and other authorities.

Figure 4-2: Gross fixed capital formation

in percent of GDP⁵⁶



* Data for 1994 are IMF estimates.

Source: IMF (1995: 40-41).

Sixth, as discussed further below, the crumbling of controls in the years which led to the break-up of the SU and in its aftermath have paved the way to far-reaching asset stripping, and theft of resources and final goods in all branches of industry and the economy as a whole, and considerable capital flight. Illegal sales of petrol and petroleum products are widely reported and have been conducted for years on a systematic and organised way (cf. Goltz 1994: 334-

⁵⁶ Gross fixed capital formation = gross capital formation - changes in stocks. For a definition of gross fixed capital formation and methods of compilation, see CCEET (1993c: 51-53). Investment data have to be judged with caution, due to problems of definition, accounting (which is particularly difficult in an inflationary environment) and coverage. Changes of stocks were not considered here, as they are subject to serious revaluation difficulties during periods of high inflation and other measurement problems. Table 4-5 indicates that changes of stocks and gross fixed capital formation go in the same direction, which does not comply with aggregate demand based investment theories.

335).⁵⁷ There are three ways of systematic oil theft: (1) underreporting local production, (2) over-reporting local consumption, (3) over-reporting refinery fuel consumption and loss. Considering that natural gas was the main fuel of domestic and industrial end-users until in 1992 when power stations were switched to fuel oil, domestic consumption has been extremely high (see Table 4-3 and Table 4-7).

Table 4-3: Refinery production and uses

(in thousand tons)

	1985	1986	1987	1988	1989	1990	1991
Total crude refined	21118.0	22022.1	22101.4	21699.6	18395.3	16331.6	15827.0
of which:	12386.0	12702.6	13169.4	13258.0	12603.6	12072.9	11087.0
Azerbaijan crude							
Products produced	20262.9	21715.9	21081.5	20799.1	17539.3	15617.6	15192.9
Refinery fuel & loss	855.1	306.2	1019.9	900.5	856	714	634.1
Apparent domestic consumption	7089.5	7501.7	7282.2	7468.8	6895.8	6530.0	7079.1

Source: IMF (1992: 76)

Under-reporting of official production figures and illegal sale of final manufacturing goods is widely reported. Asset stripping is particularly serious in enterprises producing intermediate and final goods which cannot easily be illegally sold on.⁵⁸ Equally, capital flight, e.g. in form of under-invoicing of exports and over-invoicing of imports, is regarded as a serious problem.⁵⁹ There are discussions to grant amnesty to Azeris who are willing to repatriate their illegally acquired funds and hence legalise their theft retrospectively. Such a step

⁵⁷ For example, Rasul Bayram oglu Guliyev, the present speaker of parliament, had been previously first chief engineer (1971-1980) at the Baku Oil Refinery (since 1991 renamed Azneftiyag) and later General Director. He was appointed Deputy President of the State Oil Company under Elchibey in 1992. He is regarded as the representative for the oil industry in the establishment and is alleged as worth a few hundred million US\$.

⁵⁸ Asset stripping is also acknowledged by IMF (1995: 6).

⁵⁹ For example, the preliminary balance of payments statement for 1992 prepared by IMF staff and Azeri authorities implies an unexplained negative residual of close to US\$800 million, as the current account, coupled with identified capital inflows, is not matched by an increase in official foreign exchange reserves (IMF 1993: 5).

would find broad support in the population and the establishment, as it is hoped that it will bring more stability and vital reinvestments.

Triggered by these factors, the Azeri economy suffered a cumulative decline in real GDP of 60 percent between 1990 and 1994. As Table 4-4 shows, the cumulative economic decline is far above the average decline in the whole FSU (which was 44 percent). Table 4-5 shows a breakdown of GDP by sector of origin and final use.⁶⁰ Table 4-11 documents the decline in production of selected industrial goods, which reveal a cumulative decline between 1989 and 1994 of up to 95.7 percent in heavy industry (steel pipes), 94.5 percent decline in oil extraction equipment production, 70.3 percent decline in the production of airconditioners, and 64.3 percent decline in the production of cotton fibre.

As Figure 4-3 indicates, the drop in power consumption falls far short of the measured fall in GDP.⁶¹ The cumulative change of power consumption in the period 1989-94 has been -24.5 whilst the cumulative change in GDP has been -59.2. This could be interpreted as an indicator for an overestimation of GDP decline in official data. However, electricity consumption is not a reliable proxy indicator for changes in real GDP, as (1) there are no data available of the

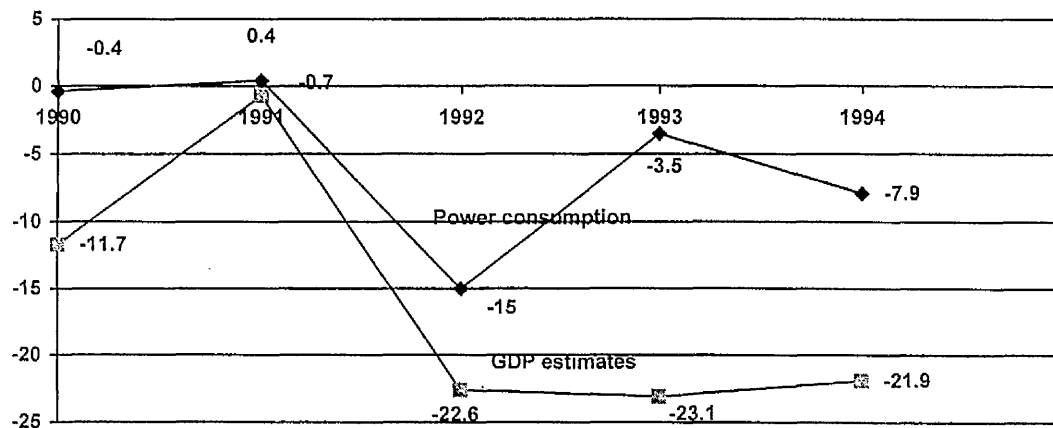
⁶⁰ As indicated earlier, real sector data in Azerbaijan have to be interpreted with caution, due to poor coverage of official statistics, low response ratios to statistical questionnaires (as ASSC has lost its leverage on respondents), and systematic underreporting by enterprises to avoid taxation and to cover up illegal sales and asset stripping. Similarly, systematic underreporting can be expected in household surveys. First attempts to compile national accounts according to System of National Accounts (SNA) classifications have only been made in 1990 in the FSU (cf. CCEET 1993c; IMF et al. 1991/1: 133-171). Due to the break up of the Soviet Union a full adoption of the new system was delayed in most republics, which continued to prepare national accounts according to the System of Balances of the National Economy of the FSU. In Azerbaijan national accounts were only prepared according to SNA standards in 1995. There is a lack of reliable price statistics. Consumer price indices have only been prepared since 1993. Labour market data are incomplete, and first attempts at a systematic recording of data have only made recently (Table 4-6 displays data from traditional series). There are impressive complete population surveys of the newly emerging private sector (mainly shops, service outlets, and restaurants) since 1994, although response ratios are low. On the whole, methodological changes in Azeri statistics are not well documented and, apparently, even employees of the ASSC are not always familiar with these changes.

⁶¹ Dubozi and Pohl (1995) recommend electricity consumption as a proxy indicator for changes in real GDP level, due to the discrepancies of officially recorded GDP estimates. Their study indicates that in the CIS countries' electricity consumption has declined far less than officially recorded GDP, whilst in Eastern Europe the fall in electricity consumption corresponds more to the fall in GDP.

industrial share of total electricity consumption and domestic consumption has remained equal,⁶² (2) some branches use the same amount of power for less production particularly due to lack of incentives for energy saving, (3) due to outdated and badly maintained power stations and the whole electricity system, there are reportedly high production losses, and (4) other energy sources of industry are not considered.

Figure 4-3: Growth in power consumption and real GDP

(annual change in percent)



Source: EBRD (1995: 182)

Real wages have fallen over several years with an average drop of almost 60 percent in 1994 (IMF 1995: 10).⁶³ According to IMF (1995: 100) calculations, in dollar terms, monthly average wages dropped from about US\$17 (1993 average) to US\$8 in January 1995.⁶⁴ However, average disposable income has likely fallen less than real wages as private households were supplementing

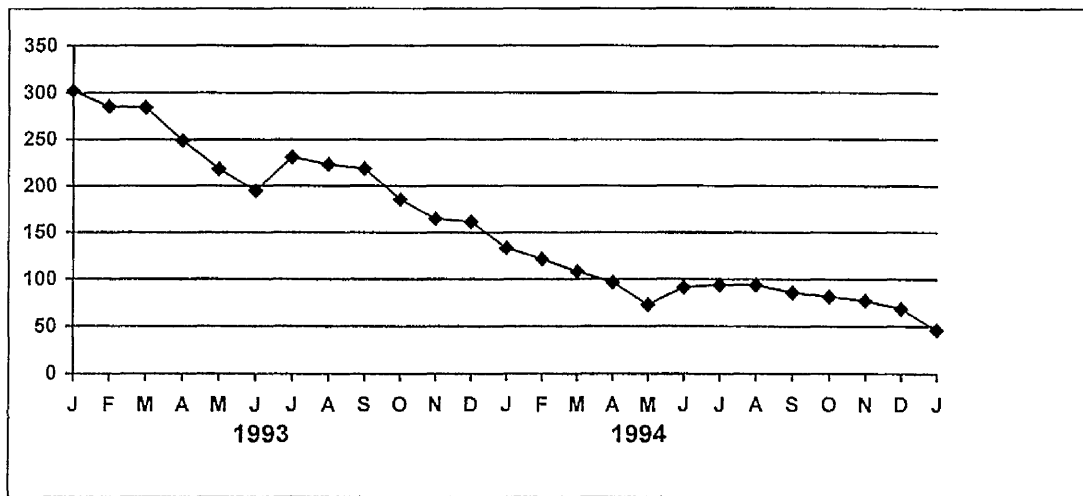
⁶² One could even assume that domestic consumption has increased, as the unemployed and under-employed cannot afford to go out and with unchanged electricity prices, there is no incentive for energy saving. Moreover, the country was swamped with new hi-fi equipment and other domestic electrical goods.

⁶³ A consumer price index is only available from 1993 (based on a survey of 1500 low income households, conducted in 1993). The consumer price index is based on a basket of 1144 products (grouped in nine categories). However, consumption patterns vary drastically between the 25 locations, where prices are monitored. It is questionable how far the consumer price index is accounting for these drastic variations. There are also problems of accuracy in data collection.

⁶⁴ According to calculations of the author, a family of four required in Baku in January 1995 US\$120 just to cover the food bill and absolute necessities.

official wages with incomes from work in the informal sector, self-employment and permanent dissaving (i.e. selling of flats, consumer durables, and valuables).

Figure 4-4: Real average wage index (Dec. 1990 = 100)



Source: IMF (1995: 51)

Official labour market figures presented in Table 4-6 show for the years 1990-1994 a cumulative decline in the labour force in industry of only 20.3%. However, de facto employment is far lower in industry as stated in the official statistics, since short-time working and enforced unpaid 'holidays' are reportedly quite common. Many workers who are still officially employed by enterprises have drifted into the informal sector. The situation is similar in other sectors. Unemployment rates can be expected to rise drastically once industrial restructuring is more decisively embarked upon.

Azerbaijan's present social safety net will be unable to cushion the impact of the massive restructuring ahead or even when 'savings'⁶⁵ of the population have been exhausted.⁶⁶ The post-Soviet safety net consists of (1) a system of

⁶⁵ Savings include all possessions up to a wedding ring.

⁶⁶ Many Baku pensioners are moving to Turkmenistan as food prices are lower there and they can survive on their pensions.

minimum wages⁶⁷ on the basis of which wages of budget organisations, pensions, and social benefits are indexed;⁶⁸ (2) the Social Protection Fund from which pensions and social benefits are paid;⁶⁹ and (3) the Employment Fund which covers unemployment benefit and training schemes.⁷⁰ Expenditures of both funds accounted for 9.8% of GDP in 1992, 8% in 1993, and only 5.9% in 1994 (IMF 1995: 54).

⁶⁷ Minimum wages are based on the consumer price index. However, they seem to have no relation to real living costs, as the CPI is related to official prices whilst most of the economy is informal. A senior member of the Azeri parliamentary commission on social protection issues could not believe it when the author informed him that the minimum wage was AzM 900 (the equivalent of US\$1 in May 1994) when interviewed in May 1994. He insisted it had to be at least AzM9000.

Minimum wages (1991-1995)

<i>Date of change</i>	<i>before April 1991</i>	<i>April 1991</i>	<i>January 1992</i>	<i>July 1992</i>	<i>December 1992</i>	<i>January 1993</i>	<i>November 1993</i>	<i>June 1994</i>	<i>October 1994</i>
Minimum wage: in AzM	7	13	31.7	70	250	300	900	2000	4000
in US\$	12.68	4.71	2.79	5.88	5.62	6.21	4.54	2.05	1.81

Source: Author's research

⁶⁸ Indexation of wages of budget organisations (i.e. non-self supporting enterprises like general administration and public utilities) was already discussed from the beginning of 1992. However the law on 'Wage Indexation', passed in January 1993, only became effective in August 1993.

⁶⁹ The Social Protection Fund comprises the former Social Fund and the Pension Fund. It is financed through both the payroll tax and the state budget.

⁷⁰ The Employment Fund was set up in October 1991 and is administered by the Ministry of Labour and Social Protection. It is funded through the payroll tax and the state budget.

Table 4-4: Comparative economic growth in PCPEs (percentage changes)

Countries	1990	1991	1992	1993	1994	Level of real GDP in 1994 1989 = 100
Albania	-10	-28	-10	11	7	69
Armenia	-7	-11	-52	-15	5	36
Azerbaijan	-12	-1	-23	-23	-21	40
Belarus	-3	-1	-10	-12	-20	61
Bulgaria	-9	-12	-7	-2	1	74
Croatia	-9	-14	-9	-3	1	70
Czech Republic	0	-14	-6	-1	3	82
Estonia	-8	-11	-14	-7	-3	64
FYR Macedonia	-10	-12	-21	-8	-4	55
Georgia	-12	-14	-40	-39	-35	18
Hungary	-4	-12	-3	-1	3	83
Kazakhstan	0	-13	-13	-12	-25	50
Kyrgyzstan	3	-5	-25	-16	-27	45
Latvia	3	-8	-35	-15	2	53
Lithuania	-5	-13	-38	-24	2	40
Moldova	-2	-18	-29	-1	-31	40
Poland	-12	-7	3	4	6	93
Romania	-6	-13	-9	1	4	78
Russia	-4	-13	-15	-9	-13	56
Slovak Republic	0	-15	-6	-4	5	81
Slovenia	-5	-8	-5	1	6	89
Tajikistan	-2	-7	-29	-11	-21	46
Turkmenistan	2	-5	-5	-10	-20	66
Ukraine	-3	-12	-17	-17	-23	45
Uzbekistan	2	-1	-11	-2	-4	86
FSU*	-4	-12	-15	-10	-14	56

* All countries of the FSU, except Estonia, Latvia and Lithuania. Estimates for real GDP represent weighted averages.

Source: EBRD and own calculations.

Table 4-5: Gross Domestic Product by sector of origin and final use
(in percent of GDP)

	1990	1991	1992	1993	1994
GDP at current prices in AzM billion ^a	1.5	2.7	24.1	157.1	1676.4
GDP in constant prices 1990=100 ^b	1466.0	1455.77	1126.8	866.4	676.7
Percentage change of real GDP ^c	-11.7	-0.7	-22.6	-23.1	-21.1
GDP by sector of origin (in percent of GDP)					
Total	100	100	100	100	100
Industry	22	30	31	25	25 ^c
Agriculture	26	39	27	27	30 ^c
Construction	8	8	8	7	4 ^c
Transport	7	7	4	7	7 ^c
Other	38	16	30	34	34 ^c
GDP by final use					
Total	100	100	100	100	100
Final consumption	69	90	86	97	92 ^c
Gross fixed capital formation	20	15	5	21	21 ^c
Changes in inventories	6	-11	-24	1	1 ^c
Exports	43	59	91	58	58 ^c
Imports	39	53	57	77	71 ^c
Net Exports	5	6	33	-19	-14

^a ASSC estimates. Exchange rate unknown. (GDP figures for 1990-1992 are only available in roubles).

^b ASSC estimates. Price index unknown.

^c IMF staff estimates.

Source: ASSC and IMF (1995: 40-41).

Table 4-6: Labour market

(thousands)

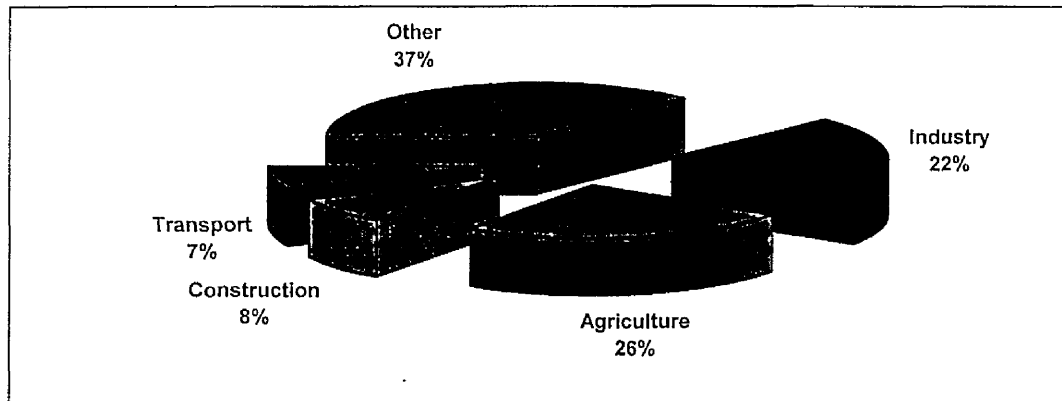
	1985	1990	1991		1992		1993		1994	
			Number	Percentage change	Number	Percentage change	Number	Percentage change	Number	Percentage change
Total population	6705.7	7119.8	7242	1.7	7296	1	7399	1.4	7487	1.2
Population at working age*	3740.3	3899.0	3833.5	-1.7	3936	2.7	4013	2	3998	-0.4
Labour force					3436		3513	2.2	3398	-3.3
Total employment	2619.2	2788.6	2901.1	4	2743	-5.4	2710	-1.2	2587	-4.5
of which										
Industry	474.1	469.1	458.8	-2.2	374	-18.5	392	4.7	374	-4.6
Public Services					603		642	6.3	653	1.7
Agriculture	870.3	898.6	977.6	8.8	1015	3.8	944	-7	895	-5.2
Unemployment					693	-	802.9	15.9	810.9	1
Unemployment rate					20.2	-	22.9		23.9	
Registered unemployed					7	-	13	98.1	22	66.9
Benefit recipients					6	-	5	-15.2	5	0
Pensioners	625.9	722.1	743.5	3	774.5	4.2	802.6	3.6	819.7	2.1

* working age: males 16-59 years and women 16-54 years.

Source: ASSC, AME, Ministry of Social Protection, and own calculations.

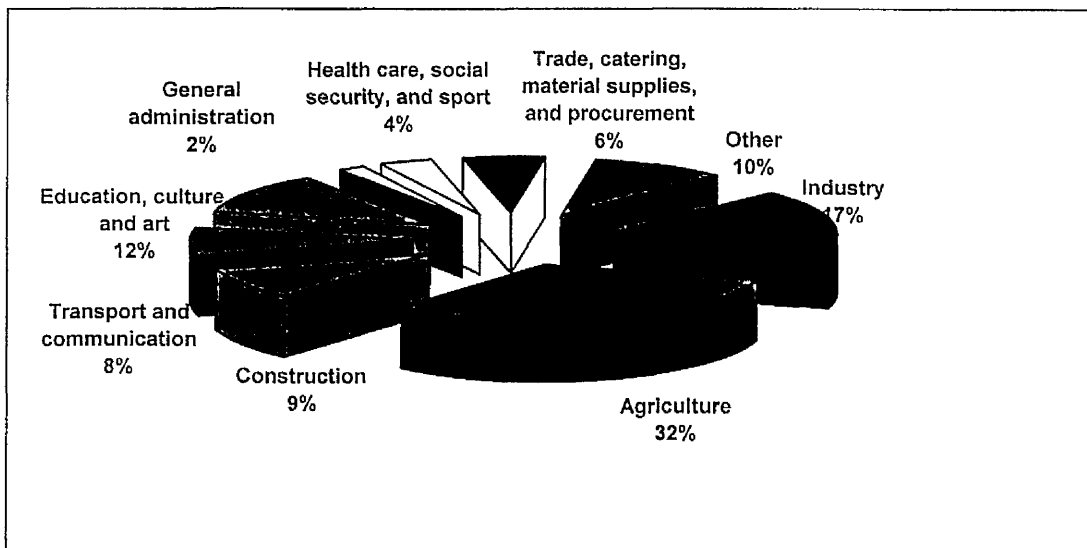
4.2.2 Economic structure

Figure 4-5: Gross Domestic Product by sector of economic activity (1990)



Source: ASSC

Figure 4-6: Employment by sector of economic activity (1990)



Source: ASSC

Although the Azeri economy has experienced early industrialisation due to the oil boom at the end of the last century, the agricultural sector remains the backbone of the economy, with 26% share of GDP in 1990 (see Figure 4-5) and a 32% share of total employment (see Figure 4-6). Officially production continues to be organised in 1160 co-operative farms (the so-called kolkhozes and interkhozes) and 850

state farms (the so called sovkhozes).⁷¹ There are also 220 registered small private farms and a significant amount of privately utilised allotments and household plots. In practice, both sovkhozes and kolkhozes have disintegrated and their resources are utilised for informal production.⁷² The land reform planned since 1991 has not been carried out yet. Legislation for its implementation had not been prepared by January 1995.⁷³ According to IMF (1995: 4) 57% of fruits and vegetables and 80% of domestic meat and milk supplies are already produced privately or informally. Similarly, the distributive infrastructure of the Ministry of Agriculture, the Ministry of Trade, and Azerittifak,⁷⁴ between which the domestic food distribution was divided, has deteriorated. Production figures of main crops are presented in Figure 4-7. They consist of wheat (mainly grain), cotton, tobacco, potatoes, other vegetables, grapes, watermelons, other fruit (mainly pomegranates, apples, and pears), and tea.⁷⁵ The official production of all crops has a declining trend. Official meat, fish and dairy products also have a declining trend. Dairy products and cereals are mainly imported.⁷⁶ However, according to officials in the Ministry of Economy, only between 60 and 70 percent of the demand for meat, dairy products, poultry, fish and margarine could be satisfied prior to independence and both agricultural production and food processing were key areas of concern of the old regime.

⁷¹ Briefings by staff of the CMA and AME to the author.

⁷² Sovkhozes and kolkhozes have been reportedly relatively well-equipped, although maintenance and asset stripping is also a problem.

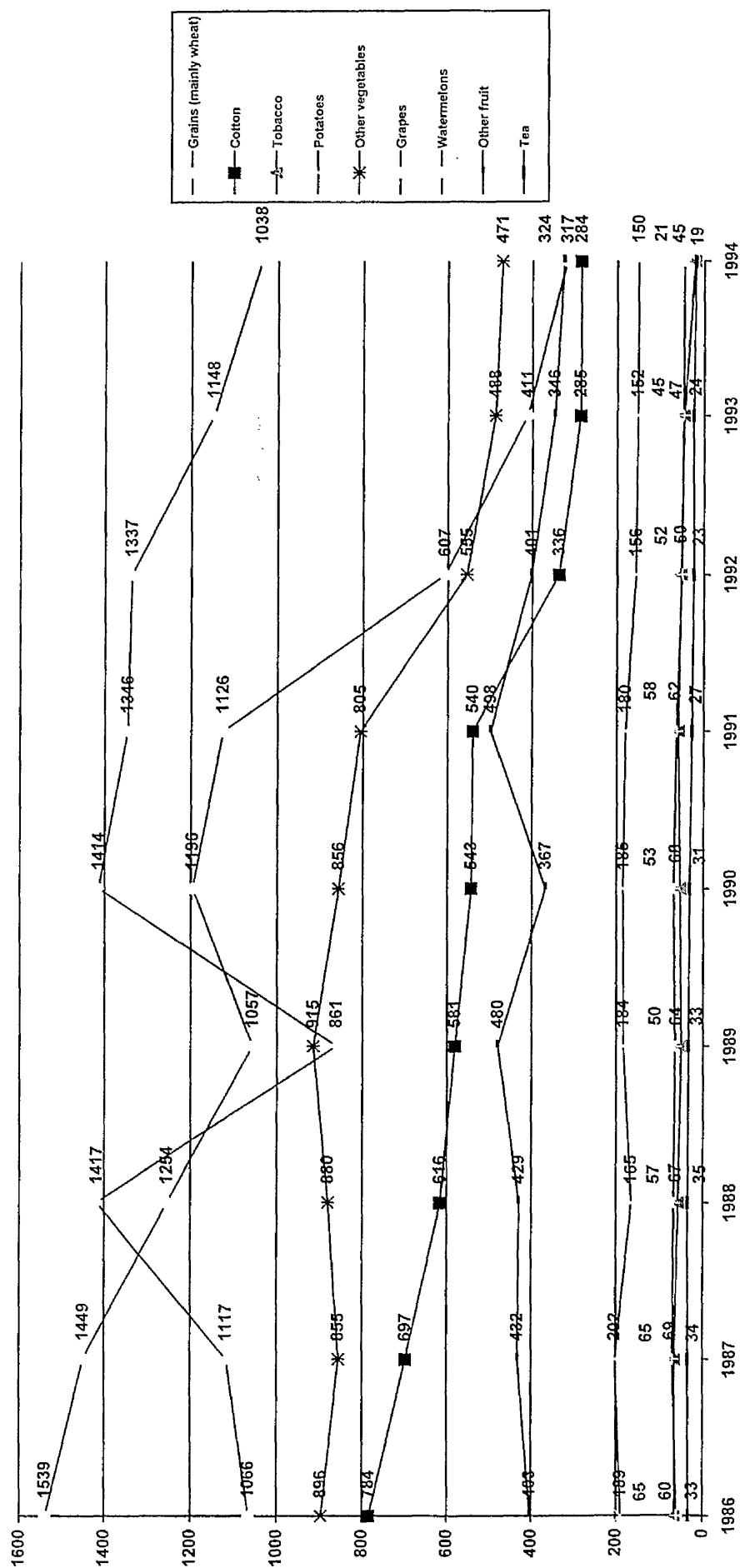
⁷³ See also Introduction of chapter 5.

⁷⁴ Azerittifak is the Azeri Union of Consumer Societies.

⁷⁵ Briefings by staff of the CMA and AME to the author.

⁷⁶ From Turkey, Russia, and the European Union, partially under the humanitarian grant and loan programmes according to respondents.

Figure 4-7: Agricultural Production by major crops
in thousand of tons



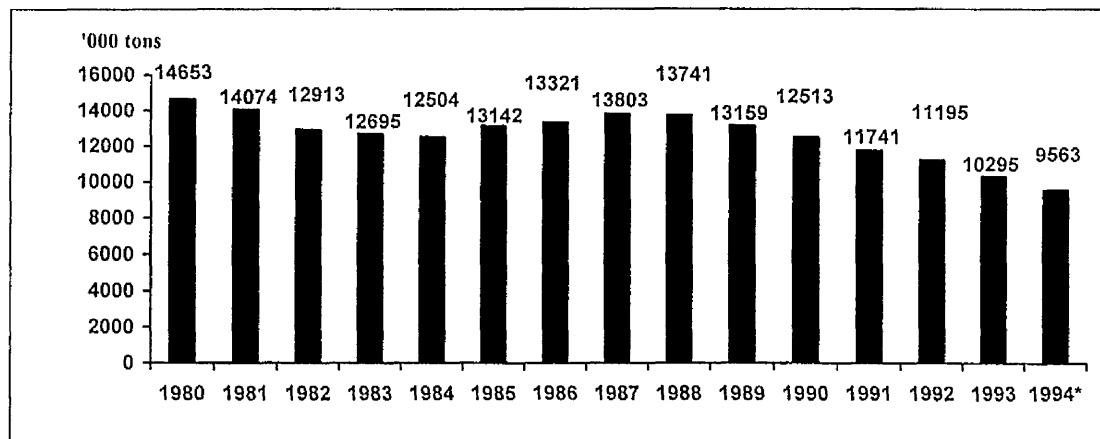
1994 data are estimates.

Source: ARDSK (1992 a and b, 1993 a and b, 1994 a and b, 1995).

In 1990 Azerbaijan's industrial sector accounted for 22 percent of GDP (see Figure 4-5) and employed 17 percent of the country's employed labour force. As mentioned above, traditionally the oil-related branches have dominated the industrial sector.⁷⁷ Official crude oil production has declined by 27.3% (see Figure 4-8) between 1989 and 1994, which is less than the decline of most manufacturing products (see Table 4-11). Remaining proven oil reserves are estimated according to CMA staff at around 1 billion tons and there are also substantial natural gas resources. Unexplored oil and gas resources are also expected to be significant. Present oil extraction and processing has been extremely wasteful due to poor reservoir management, inefficient production practices, and obsolete equipment in both producing wells and refineries. Production causes substantial environmental pollution through oil spillage, inappropriate disposal of formation water, and wasteful venting of gas. There is also a problem of radiation set free in the production process which could be reduced by adequate equipment. The Baku peninsula in places is infernal with obsolete oil pumps being simply abandoned to rot and 7400 hectares contaminated with oil and brine containing heavy metals (e.g. chromium, lead and mercury) with serious effects on groundwater.⁷⁸ Table 4-3 indicates that around 4.5 percent of oil is lost in the refinery process. The two refineries are characterised by obsolete technology, of both processing units and control systems, and over-capacity. There are plans for modernisation.

⁷⁷ In 1823 the first paraffin plant in the world was built processing oil extracted in Baku. The first oil refinery was set up in a suburb of Baku. The number of oil wells rose from nine in 1879 to 1710 around 1900. Based on the oil revenues, other industries were established in the second half of the 19th century, including machine building plants, mechanised workshops, textile mills, and tobacco processing plants. By 1910 Baku supplied half of the world's oil requirement. Revolts of the Baku oil workers as early as 1903 led to the establishment of the Baku commune in 1917, the 26 Commissars of which were driven to Turkmenistan and murdered by the British on 20 September 1918. Clara Zetkin the German socialist wrote a colourful report of this period in Azerbaijan, see Zetkin (1926). Industrialisation was furthered in the Soviet period with strong emphasis on petrochemicals and oil production. The importance of Baku industry grew during the World War II, especially when German troops had already headed as far as Grozny. According to official sources, the Soviet military effort was two-thirds fuelled with oil from Azerbaijan, and production culminated in an all time high of 450,000 bpd in 1941. At every official dinner the author attended in Azerbaijan, at least 15 minutes of the speeches and two glasses of vodka were devoted to the crucial role of Azeri oil in World War II, and that in fact, Azerbaijan had won the war for the Soviet Union.

⁷⁸ Briefings by Azeri environmental experts to the author.

Figure 4-8: Crude Oil Production*(in thousands of tons)*

* estimate.

Source: CMA

Around 1.4 billion cubic meters of wet gas have been annually vented offshore.⁷⁹ This corresponds to 16.1 percent of the natural gas requirements of the country in 1994. The project to build a new gas compressor station in Bakhar leased from the American oil company Pennzoil and a pipeline from the Oil Rocks field to capture this otherwise vented gas of Guneshli has only been completed at the beginning of 1995 - after many complications and almost three years later than planned.⁸⁰ Around 2.4 billion cubic meters of gas are lost through transmission and distribution pipeline leakage, i.e. 25.3 percent of the entire gas requirement in 1992 (see Table 4-7).

There are quite a few production sharing projects with international oil companies in the pipeline. In September 1994 the government signed a production sharing contract with a consortium of 11 international oil companies for exploring and developing the Azeri, Chirag, and deep water Gunashli fields in the Azeri section of the Caspian Sea after three years of negotiations and 'almost'

⁷⁹ Briefings by CMA employees to the author.

⁸⁰ Goltz (1994: 335) gives the Penzoil gas compression project as an example of the state of corruption in Azerbaijan: projects which are not instantly 'income generating' in terms of bribes and other kick-backs for politicians and bureaucrats are difficult to operationalise.

ratifications.⁸¹ The contract involves estimated recoverable reserves of approximately 4 billion barrels and US\$7.5 billion investment over 15 years.⁸² The manufacturing sector is analysed in section 4.2.3.

Azerbaijan's power generation was reportedly based largely on natural gas mainly imported from Turkmenistan.⁸³ These imports were partially due to the political rationale of reinforcing inter-republican dependency and partially due to outright central planning failures as transport costs including losses through transmission were neglected. With the break up of the Soviet Union, increasing trade complications, and Turkmenistan's gas price being gradually moved towards world market prices, power stations were switched to fuel oil consumption, which causes additional inefficiencies in power generation.⁸⁴ As indicated in Table 4-8, Azerbaijan's economy is highly energy-intensive, even by the standards of the FSU. Compared with the unweighted average of FSU countries, the energy intensity of GDP in 1992 was about 55.8 percent higher and compared with the weighted average of OECD countries, it was close to 10 times higher.

Construction accounted for eight percent of GDP in 1990 and employed about nine percent of total employment (see Figure 4-5 and Figure 4-6). Due to lack of investments and foreign competition the construction sector has sharply declined since then and only accounts for four percent of GDP in 1994. Most prestigious construction projects are reportedly carried out by Turkish firms. There are prospects for the sector once the work on the new pipeline routes has begun.

⁸¹ In May 1996 the consortium consisted of BP, with 17.1267 percent, Amoco with 17.01 percent, SOCAR (State Oil Company of Azerbaijan) with 10 percent, Lukoil (Russian State Oil Company) with 10 percent, Unocal with 9.52 percent, Statoil (Norway) with 8.5633 percent, Itochu (Japan) with 7.45 percent, TPAO (Turkish State Oil Company), with 6.75 percent, Exxon with 5 percent, Pennzoil with 4.8175 percent, Ramco with 2.0825 percent, and DNKL with 1.68 percent. Itochu bought McDermott's share of 2.45% and 5% of Pennzoil's original share of 9.8175%.

⁸² See also section 4.3.

⁸³ Seven percent of energy is reportedly generated by hydropower stations mainly at Mingeshau and Shamkor. The power station at Mingeshau still consists partially of equipment originating from reparations from Japan after World War II.

⁸⁴ Briefings by energy sector employees to the author.

Table 4-7: Energy balance

	1991	1992	1993	1994
Crude oil (in millions of tons)				
Production ^a	11.7	11.2	10.3	9.5
Net trade	4.2	3.5	1.4	1.8
Exports	8.3	5.4	1.6	1.8
Imports	4.1	1.9	0.2	..
Apparent use ^b	7.5	7.7	8.9	7.6
Natural gas (in billions of cubic meters)				
Production (net of venting) ^c	8.6	7.8	6.8	6.2
Net trade	-8.2	-3.9	-2.5	-2.5
Exports	..	..	..	..
Imports	8.2	3.9	2.5	2.5
Losses	3.1	2.4	^d	^d
Apparent use	13.7	9.3	9.3	8.7
Energy trade balance	-3.1	..	-0.9	-0.4

^a Production of Azeri crude oil.^b Apparent use equals production plus net imports.^c Vented gas is excluded.^d No data available.^e Defined in million tons of oil, with one ton of oil equalling 1120 cubic metres of gas.

Source: IMF (1995: 64) and World Bank (1993: 120).

Table 4-8: Comparative energy intensity in the FSU and OECD countries (1992)

Country	TPES ^a /GDP ratios (tonnes oil equivalent per US\$ '000)	TPES ^a per capita (tonnes oil equivalent)
FSU countries ^b	2.78	4.79
Azerbaijan	4.33	3.69
Belarus	1.29	3.76
Estonia	1.70	4.74
Kazakhstan	3.44	5.74
Russia	2.69	7.24
Turkmenistan	3.02	3.45
Ukraine	2.98	4.94
Uzbekistan	3.70	3.11
OECD countries ^c	0.40	4.84
Canada	0.55	7.88
France	0.37	4.03
Germany	0.41	4.22
Italy	0.32	2.75
Japan	0.26	3.63
United Kingdom	0.41	3.74
United States	0.43	7.78

^a Total primary energy supply (TPES)^b Unweighted average^c Weighted average of all OECD countries

Source: EBRD (1995: 77)

Transport accounted for seven percent of GDP and employed eight percent of the labour force (see Figure 4-5 and Figure 4-6). The sector is reportedly characterised by an inadequate infrastructure and lack of maintenance. Both rail and road networks are focused on Moscow. Conflicts in Georgia beginning in 1994, and the closing of the northern trade route, in late 1994, due to the conflict in Chechnya, have been a further serious impediment to economic growth and

development, hindering the flow of production inputs and output distribution. The most important means of transport have been rail and the Caspian sea fleet. Azerbaijan reportedly has a rail network of 2000 km. However, both railways and sea fleet are in a destitute situation. There has been practically no maintenance except for emergency work. In case of the railways it was reported that theft of equipment and installations, which are sold as scrap metal, is quite common.

The service sector including social services, education, culture and art have been given high priority in the past employing 34 percent of the employed labour force and a 37 percent share of GDP in 1990 (see Figure 4-5 and Figure 4-6). Due to lack of funding, education and health services are rapidly declining with many academics and doctors either emigrating or seeking employment in trading (i.e. small shops and operations) and other informal activities.

4.2.3 Overview of the manufacturing sector

Besides the historically dominant oil industry Azerbaijan has been able to develop and maintain a diversified manufacturing sector, which was highly integrated into the economy of the FSU (see Table 4-10 and Table 4-11). As discussed above, the main problems of the sector arise from (1) its extreme dependency on raw materials and intermediary goods, (2) disruptions in trade due to the conflicts in Georgia and Chechnya which led to a closure of trade routes, (3) changes in domestic relative prices and adoption of world market prices for raw materials and intermediary goods, (4) partially aggressive international competition combined with massive changes in consumption patterns all over the FSU, and (5) a largely dilapidated and obsolete capital stock which requires urgent upgrading and modernisation. Production has slumped in all branches over the last six years (see Table 4-11).

Table 4-10 indicates that heavy industry employed 47 percent of the industrial workforce and produced 39 percent of industrial production in 1991 (under the previous distorted pricing scheme). Heavy industry consists mainly of fuel industry (6% of industrial employment) which was already discussed above, metallurgy (5% of industrial employment), machine building including electrical

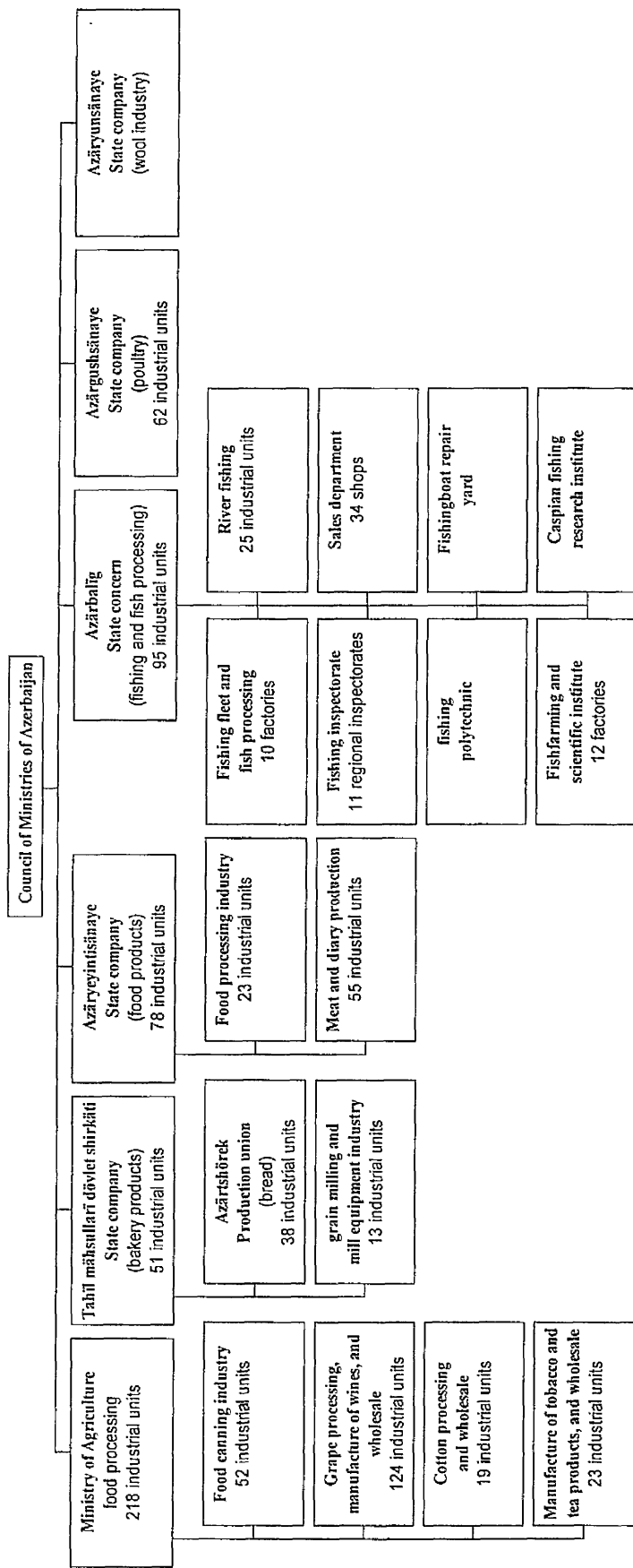
machinery (26% of industrial employment), and the energy sector (5% of industrial employment). Nearly all industrial units of the metallurgical branch are organised under the Metalurkia State Company (see Table 4-12). This quasi-holding structure has taken over the function of the All Union Ministry of Ferrous and Non-Ferrous Industries to which all enterprises had been previously subordinated.⁸⁵ As Table 4-11 indicates, there has been a sharp decline in all products of this industry with steel production amounting only to 5.5 percent and steel pipes to 4.3 percent of 1989 output in 1994. Table 4-12 gives a short description of the state and major problems of this company. Gold mining is organised under the State concern Azärgözil. Industrial units of the machine building and electrical machinery are organised under one state company and eight state production unions (see Table 4-18). A few enterprises are independent and directly subordinated to the CMA. Table 4-12 delineates the most important enterprises: (1) the State company Azärkimyamash, the quasi-holding company of the equipment industry for chemical and oil industry, and some of its plants, (2) the most important plants of the production union Tshinar, (3) the most important plants of the 'science-production' association Bakkonditionär, and two independent enterprises. As pointed out in Table 4-12, the oil field equipment industry used to be quite significant and constitutes the largest concentration of this branch after the United States. Production had sharply declined by 1994 with output constituting 5.6 percent in the oil equipment industry and 7.1 percent in the pumping equipment industry of 1989 output (see Table 4-11). The air-conditioner plant has a monopoly in the FSU. Its official production amounted to 29.7 percent of 1989 output in 1994 (see Table 4-11).

The food and beverage industry employed 14 percent of the entire industrial workforce in 1991 (see Table 4-10). Due to the collapse of the official agrarian sector, production in manufacture of food products and beverages has also plummeted. According to employees of the AME the industry satisfies only 10 percent of domestic demand. In an attempt to restore production by alleviating some of the control deficiencies of the centralised system, there have been a series of organisational changes since the disintegration of the Soviet Union, which had

⁸⁵ Section 4.3 discusses the present forms of enterprise control in more detail.

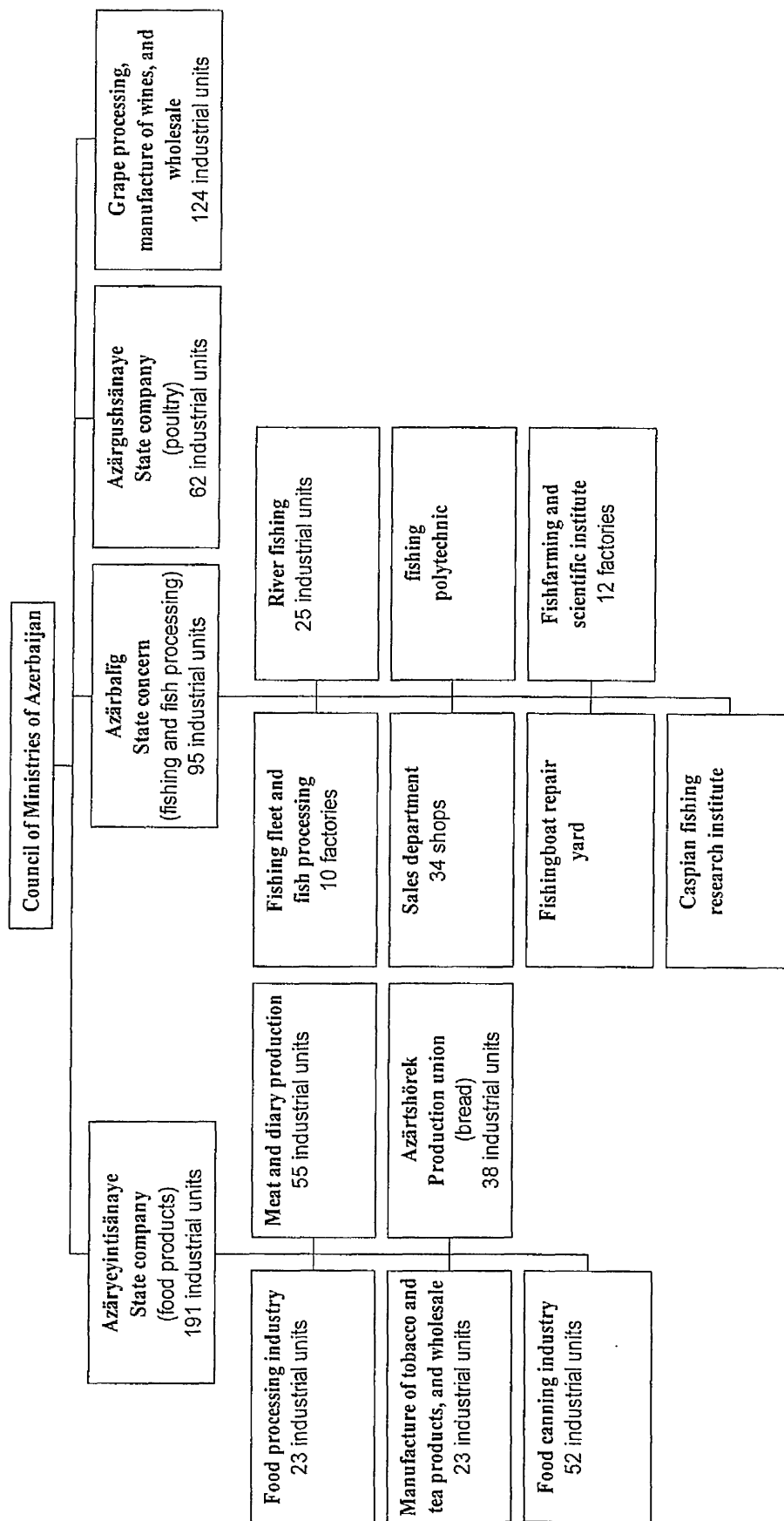
left the entire agricultural sector and the food industry under the control of the Ministry of Agriculture. The decentralisation of the Ministry and the creation of new administrative authorities reflected also the distributional struggle over resources (most eminently caviar and cotton) of different parts of the nomenklatura of the agrarian-industrial complex. The industry is presently organised under the Ministry of Agriculture, the state concern "Azärbalig" (fishing and fish processing), the state company "Azäryeyintisänaye" (processed food products), the state company "Tahil mähsulları dövlät shirkäti" (bakery products), and the state concern "Azärgushsänaye" (poultry). The state concern "Azäryunsänaye" (wool), tobacco and cotton processing plants are also presently classified as belonging to the food processing industry. Figure 4-9 shows the present organisation chart. There has been severe criticism of the fishing and fish processing state concern which supervises the Fishing Inspectorate as well as the fishing, as it would leave the fish reserves uncontrolled, leading to poaching and depletion of sturgeon (i.e. caviar) and salmon in the Caspian Sea. Thus it is suggested that the function of the Fishing Inspectorate is performed by the Ministry for Internal Affairs. The Light Industry State Concern ("khalg üchün mallar konzernt") would like the cotton processing under its own control. The grain milling and milling equipment industry which is reportedly in a very poor condition, is suggested to be included in the agricultural sector. Figure 4-10 shows the suggested new administrative structure of the food and beverage industry. Organisational changes had not been carried out until February 1995.

Figure 4-9: Organisational structure of the food processing and beverage industry (1994)



Source: AME

Figure 4-10: Suggested new organisational structure of the food processing and beverage industry (1994)



Source: AME

The Light industry employed 24 percent of the total industrial workforce in 1991 (see Table 4-10). It is organised under the Khalg üchün mallar (people's goods) state concern and includes household goods, textile industry (i.e. spinning, weaving, and finishing of textiles), and manufacture of leather and fur products (including footwear). The light industry and the people's goods industry (producing goods of local significance, e.g. household goods, toys, etc.) were previously under exclusive republican ministerial control, which entailed a dependency on the republican budget for investments.⁸⁶ As the republican budget was under a relatively harder budget constraint, these industries were starved of investments. According to CMA employees, 65 percent of the production facilities are more than 20 years old. 80 percent of the enterprises are reportedly large (>300 employees) and 20 percent medium sized (between 51 and 300 employees). After the disintegration of the Soviet Union the Ministry of Light Industry and the Ministry of People's Goods merged and renamed themselves into the 'People's goods state concern', otherwise retaining their organisational structure. The textile industry accounts for 173 of the 251 industrial units. From 1989 to 1994 the production of cotton fabric has fallen by 64.4 percent, of silk and wool fabric 15 percent, and of knitted wear 75.5 percent (see Table 4-11). Despite the domestic production of cotton the industry is highly dependent on inputs from other republics. For example, the domestically produced cotton thread is too thick for the knitted wear production facilities.

Manufacturing of wood and paper products, which includes printing, is a relatively small industry, employing only 3 percent of total industrial employment. There is no local paper industry. Timber production has fallen by 95.5 percent from 1989 to 1994. The industry is organised under the state production union Azärmäshä.

The chemical industry employed 6 percent of total industrial workforce in 1991 (see Table 4-10). It used to be directly controlled by the All Union Ministry of the Chemical and Petroleum Refining Industry and is now organised under the State Company Azärkimya. The industry consists of 36 industrial units organised

⁸⁶ The information of the following section is based on the author's transcripts of interviews with the management and employees of plants, CMA and AME staff.

in 11 production unions and factories (see Table 4-9). The Production Union Kimyasānaye used to produce 95 percent of the sulphanol supply of the FSU. The decline of production can be seen in Table 4-9 and Table 4-11.

Table 4-9: Capacity of main products of the state company Azärkimya
in thousand tons

Production Union/ Product	Capacity	1990	Capacity utilisation	1993	Capacity utilisation
Production Union Üzvüsinter					
Polyethylen	156	49.2	31.5	19.2	12.3
Epoksid	15.4	9.9	64.3	1.2	7.7
Polyether	10.8	4.3	39.8	0.8	7.4
Kalium	110	52.7	47.9	6.0	5.5
Epichloridrin	24	13.3	55.4	3.8	15.8
Dichlorinethan	20	12.6	63	5.2	26
Production Union Kimyasānaye					
Sulphanol	143	130.4	91.2	23.3	16.3
Caustic soda	145	106.9	73.7	48.8	33.7
Alkilbenzol	30	-	-	-	-
Production Union Sintezkautshuk					
Synthetic india rubber and latex	129	85.4	66.2	9.3	7.2
Production Union Sumgaitmäischätkimya					
Synthetic detergents	90.0	83.0	92.2	39.0	43.3
Production Union Azärrezintekhnika					
Conveyer belts (000 items)	3592	1248	34.7	833	23.2
Baku tire factory					
tiers (000 items)	1898	1122	59.1	234.3	12.3
Superphosphate Factory					
Phosphate fertiliser	214	150	70.1	20.6	9.6
Sulphate acid	n/a	452.6	-	97.2	-
Plastic processing Factory					
Polyethylen cover (000 tons)	12	6.1	50.8	3.2	26.7
Polyethylen pipes (000 tons)	7	1.7	24.3	0.23	0.3
Baku Iodin factory					
Iodin (ton)	70	70.3	100.4	33.1	47.3
Caliumiodin (ton)	140	49.8	35.6	33.1	23.6
New Iodinbrom factory in Neftshala					
Iodin	234	100	42.7	75	32.1
Baku Chemical-pharmaceutics factory					
Medication ampoules (000)	n/a	206.2	-	19	-
Tablets (000)	105	95.9	91.3	46.8	44.6

Source: Azärkimya State Company

The chemical industry is concentrated in Sumgait, which is situated on the Apsheron peninsula opposite to Baku and considered the biggest source of

pollution of the Caspian Sea.⁸⁷ Before its decline, according to the Committee of Ecology and Environmental Control, the chemical industry emitted 112400 tons of hazardous substances per year into the atmosphere.⁸⁸ Due to lack of adequate purifying facilities for both industrial and domestic sewage the concentration of oil products in coastal waters around Sumgait exceed by five times the official permissible standards, heavy metals three times, and phenol eight times.⁸⁹ Sizeable investments have to be made in environmental protective measurements in the industry and most of the facilities will have to be replaced. Even if the whole industry were completely closed down, massive investments would be required to decontaminate the whole area.

Manufacture of building materials had a share of 6 percent in total industrial employment (see Table 4-10). Table 4-11 shows a decline of 85.2 percent in reinforced concrete and 66.4 in brick production between 1989 and 1994. The decline is to a large extent due to the situation of the construction sector. However, the quality of the materials produced is also very poor, so that reportedly a lot of building materials are imported, particularly from Iran and Turkey. The industry also does not facilitate domestic resources (e.g. clay) and uses inputs from other countries of the FSU. Investments are required in order to upgrade the quality of production combined with utilising of domestic resources.

⁸⁷ In several visits to the industry in Sumgait by the author in 1994 there had been always a thick acid smoke over the whole area, although by then most of the industries were no longer even in operation.

⁸⁸ The emission included 8,500 tons of solid substances, 13,090 tons of sulphur dioxide, 11,800 tons of nitrous oxide, 42,600 tons of hydrocarbons, and 23,600 tons of carbon monoxide.

⁸⁹ In recent years even the poor facilities in place for sewage cleaning were not working due to difficulties in maintenance (i.e. spare parts were missing).

Table 4-10: Industry structure (1991-1992)

Branch	Industrial units ⁹⁰	Employees		1991		1992	
		Number	Percent share	Production Rb. mill.	Percent share	Production Rb. mill.	Percent share
Total		398498	100	24647	100	130645	100
Heavy Industry							
of which	1302	185687	47	9550	39	79185	61
Fuel industry	18	23361	6	3064	12	32190	25
Metallurgy	14	18682	5	803	3	6595	5
Machinery, equipment & electrical machinery	859	104699	26	3210	13	20872	16
Electricity, gas, steam and hot water supply	129	20255	5	785	3	11509	9
Manufacture of food products and beverages	1187	54932	14	7766	31	16282	12
Light industry							
	251	94390	24	4667	19	18692	14
Manufacture of wood and paper products,	554	11567	3	425	2	2310	2
Manufacture of chemicals, petrochemicals, and chemical products	36	25816	6	1595	6	8855	7
Manufacture of building materials	387	26106	6	644	3	5321	4

Source: ASSC

⁹⁰ In terms of business units various ministries and organisations quoted between 700 and 850 units in total.

Table 4-11: Selected industrial production

	Unit of measurement	1980	1985	1986	1987	1988	1989	1990	1991		1992		1993		1994		Level of Production in 1994 1989 = 100
									1	2	1	2	1	2	1	2	
Electricity	billions kW/year	15	20.7	21.5	22.9	23.6	23.3	23.2	23.3	0	20	-14.2	19	-5.3	18	-5.3	77.2
<i>Metal processing</i>																	
Primary Aluminium	'000 tons	58	56	57	55	55	36	27	26	-3.7	20	-23.1	13.6	-32	n/a	..	..
Alumina	'000 tons	239	385	395	415	400	380	239	276	15.5	240	-13	183.2	-23.7	n/a	..	..
Steel	'000 tons	1100	709	739	772	726	696	501	462	-7.8	413	-10.6	236	-42.9	37	-84.3	5.5
Steel pipes	'000 tons	575	582	541	566	604	584	493	411	-16.6	260	-36.7	146	-43.8	25	-82.9	4.3
<i>Machine building</i>																	
Oil extraction equipment	'000 items	4.5	6.5	6.2	6.4	6.2	5.4	5.2	4.1	-21.2	2.9	-29.3	1.9	-34.5	0.3	-84.2	5.6
Drilling equipment	'000 items	91.6	93.7	95.3	92.1	87.3	79.3	73	73	0	55	-24.7	53	-3.6	29	-45.3	36.6
Pumping equipment	'000 items	492	420	420	323	465	494	527	462	-12.3	393	-14.9	161	-59.0	35	-78.3	7.1
Electric motors	'000 items	5507	6669	6985	7223	7105	6496	4860	3761	-22.6	1837	-51.2	1355	-26.2	818	-39.6	12.6
Transformers	'000 kW amp.	1991	2411	2587	2502	2082	2410	1996	1616	-19	651	-59.7	229	-64.8	97	-57.6	4.1
<i>Building materials</i>																	
Reinforced concrete	million m ³	1564	2027	2074	2105	1912	1688	1295	1190	-8.1	989	-16.9	594	-39.9	250	-57.9	14.8
Bricks	million	1212	1392	1436	1523	1465	1454	1317	1172	-11	1062	-9.4	764	-28.1	498	-34.8	33.6
Roof tiles	million	101	112	100	116	92	85	66	78	18.2	70	-10.3	51	-27.1	14	-72.5	16.5
<i>Chemical & petro-chemical industry</i>																	
Fertilisers	'000 tons	220	306	304	313	320	275	212	189	-10.8	81	-57.1	32	-60.5	5	-84.4	1.8
Pesticides	'000 tons	14.7	15.1	14.8	10.5	5.7	5.1	2.1	6.7	319.1	6	-10.5	1	-83.3	1	..	19.6
Synthetic Rubber	tons	127	146	129	130	121	107	85	78	-8.2	28	-64.1	9.3	-66.8	n/a	..	..
Polyethylene	'000 tons	37	37	37	37	51	82	49	66	34.7	6	-90.9	..	..	..	..	..
Tires	'000 items	1681	1666	1587	1592	1483	1327	1123	870	-22.5	479	-44.9	246	-48.6	n/a	..	..
Diesel Fuel	'000 tons	3581	4500	5005	5159	5145	4236	3899	3635	-6.8	3211	-11.7	2324	-27.8	n/a	..	..
Gasoline	'000 tons	2204	1989	2150	2121	1743	1523	1472	1174	-20.3	1035	-11.8	1068	3.2	n/a	..	..
Lubricants	'000 tons	1138	1118	1132	1104	1061	934	818	763	-6.7	391	-48.8	207	-25.4	n/a	..	..
Sulphuric acid	'000 tons	652	782	839	872	846	768	603	552	-8.6	269	-51.3	141	-47.6	56	-60.3	7.3
Caustic soda	'000 tons	167	227	235	245	236	219	160	171	6.9	92	-46.2	49	-46.7	40	-18.4	18.3
Sulphanol	'000 tons	117	131	142	141	141	136	130	118	-9.2	62	-47.5	23	-62.9	7	-69.6	5.1

	Unit of measurement	1980	1985	1986	1987	1988	1989	1990	1991		1992		1993		1994		Level of Production in 1994 1989 = 100
									1	2	1	2	1	2	1	2	
Detergents	'000 tons	60.8	70.6	73.3	78.6	83.6	85.1	81.5	76.1	-6.6	52	-31.7	40	-23.1	10	-75.0	11.8
Soap	'000 tons	30.7	35.5	36.4	37.7	38.4	40.7	43.0	24.8	-42.3	17	-31.5	10	-41.2	8	-20	19.7
<i>Light Industry</i>																	
Cotton fabric	mill. m ²	114	135	115	131	127	121	102	95	-6.9	77	-18.9	98.2	27.5	77.9	-20.7	64.4
Wool fabric	mill. m ²	19	15	15	16	16	14	11	9	-18.2	7	-22.2	5.3	-24.1	2.1	-60.4	15
Silk fabric	mill. m ²	36	36	34	38	37	30	33	30	-9.1	21	-30	10.9	-48.1	4.5	-58.7	15
Stockings and socks	mill. pairs	38	42	44	44	44	43	38	35	-7.9	32	-8.6	22	-31.3	20	-9.1	46.5
Knitted wear	mill. items	30	41	42	43	43	42	37	31	-16.2	14	-54.8	11.2	-20	10.3	-8.0	24.5
Shoes	mill. pairs	18	23	23	23	20	17	15	10	-33.3	5	-50	4	-20	3	-25	17.7
<i>Consumer durables</i>																	
Crockery	'000 items	37.5	38.2	37.9	37.5	33.3	26.2	21.1	26.1	23.7	18	-31	16	-11.1	10	-37.5	38.2
Metal goods	'000 items	2779	1944	1921	1976	1893	1195	1948	724	-62.8	355	-51	257	-27.6	135	-47.5	11.3
Radios	'000 items	243	485	375	6	1	..	6	7	16.7	..	..	30	..	3	-90	..
Refrigerators	'000 items	267	302	314	332	337	354	330	313	-5.2	223	28.8	228	2.3	97	-57.5	27.4
Air conditioners	'000 items	401	429	430	429	421	401	309	295	-4.5	268	-9.1	179	-33.2	119	-33.5	29.7
Ventilators	'000 items	113	190	174	170	148	159	134	93	-30.6	41	-55.9	37	-4.8	28	-24.3	17.6
Bicycles	'000 items	60	129	139	175	183	160	130	103	-20.8	43	-58.3	51	18.6	40	-21.6	25
Children's furniture	'000 items	296	464	429	411	427	405	372	259	-30.4	..	..	..	..	..	..	..
<i>Agar-Industrial</i>																	
<i>Complex</i>																	
Cotton fibre	'000 tons	248	251	243	240	219	207	167	171	24	148	-13.5	110	-25.7	74	-32.7	35.7
Canned food	mill. tins	470	620	642	790	845	728	653	628	-3.8	508	-19.1	320	-37	186.1	41.8	25.5
Dried tea	'000 tons	n/a	8.05	n/a	n/a	n/a	n/a	7.5	6.6	-12	5.15	-22	5.24	2	6.1	16	n/a
Vodka	'000 bottles	1821	1692	1388	1050	1270	1686	1770	2407	36	1812	-24.7	618	-65.9	400	-35.3	..
Cognac	'000 bottles	1388	861	761	1295	1635	1791	1771	1954	10.3	891	-54.4	826	-7.3	407	-50.7	22.7
Grape wine	'000 bottles	10346	8248	5817	6474	8180	11369	9362	8553	-8.6	5416	-36.7	2490	-54	1008	-59.5	8.9
Champagne	'000 bottles	5780	18734	10273	14695	20858	20194	18168	16071	-11.5	17141	6.7	619	-96.4	300	-51.5	23.6
Fermented Tobacco	'000 tons	50	53	51	55	56	51	49	47	-4.1	47	0	38.1	-18.9	n/a	..	..
Cigarettes	mill. items	7673	9791	9626	8618	7327	7089	6520	7311	12.1	4886	-33.2	5335	9.2	n/a	..	..
Timber	'000 m ³	244	279	244	247	211	157	126	56	-55.6	47	-16.1	24	-48.9	7	-70.1	4.5

1 Number

2 Percentage change

Source: ASSC, AME, and own calculations.

Table 4-12: Selected manufacturing companies and plants

Name	Operating since	Value of assets ⁹¹	Workforce	Subordinated to	Production	State of production facilities and organisation	Potential exports	Required investments
Metalurkia State Company	May 1993	US\$1 billion	18600 (i.e. 5% of industrial labour force. 20% are educated to degree level and above). Suffers problems of brain drain, due to emigration of skilled personnel.	Holding structure which comprises 20 big metallurgic plants, mines, and research institutes which used to be before independence subordinated to the All Union Ministry of Ferrous and Non-Ferrous Industries. Gold mining is separately organised. Is supervised by the CMA.	<p>Extraction of iron ore, copper, alunite, and other non-ferrous ores and processing. Due to specialisation of production and the geographical distribution of productive capacity within the FSU the plants were highly vertically integrated into the Soviet production structure. Produced metals were mostly processed elsewhere in the FSU, whilst domestic industries received their metal inputs from other republics. According to ARNK (1992: 29-37) the industry has massive potential due to the so far less exploited natural resources of the country.</p> <p>The holding structure comprises the following 20 plants and research institutes:</p> <ol style="list-style-type: none"> 1. Production Association 'Azerbonuyayma', Sungait; 2. Mine Works, Dashlesan; 3. Dash-Salakhli Ore plant; 4. Production Association 'Tekrargarametal'; 5. Production Association 'Gil Toprak', Ganje; 6. Production Association 'Sungaitelvalmetal'; 7. Baku Non-Ferrous Metal Processing Plant; 8. Garadag Non-Ferrous Metal Processing Plant; 9. Zaglik Alunite Ore Works; 10. Azerbaijan Non-Ferrous Metal Processing Plant; 11. Nakhichevan Ore Works; 	<p>Holding structure was set up as defence against institutional change. No clear structures and hierarchies. Production facilities are mostly obsolete and have to be modernised. Serious problems due to vertical integration into the economy of FSU. In 1992 a rudimentary proposal for the modernisation of most metallurgic plants has been prepared by the CMA quoting roughly the financial requirements totalling 84797 roubles (US\$452.42 million with an average exchange rate of 187.43 for 1992) and US\$471.75 million (cf. ARNK 1992: 15-18). The proposal does not contain a financial plan. Most of the modernisation was scheduled to be carried out between 1993-1996. Some projects were to be implemented by 1998. For some plants joint ventures with foreign partners were proposed. Five joint ventures are presently set up, operating on a small scale (see</p>	<p>FSU markets and foreign markets.</p>	<p>Total investments of 84797 roubles (US\$452.42 million with an average exchange rate of 187.43 for 1992) and US\$471.75 million (cf. ARNK 1992: 15-18).</p>

⁹¹ Details on methods of valuation were not made available. It is assumed that in most cases a reliable valuation has not been carried out.

Name	Operating since	Value of assets	Workforce	Subordinated to	Production	State of production facilities and organisation	Potential exports	Required investments
Azneftkinyamash State Company	1991 (1993 Azneftmash and Azkinyamash were amalgamated.)	n/a	13000 (i.e. 3% of industrial labour force) Suffers problems of brain drain, due to emigration of skilled personnel, especially in research and development.	Holding structure comprising 15 plants and three research and development institutes producing chemical, refining and oil field equipment subordinated to the Council of Ministries since independence. Until 1989 its plants had been subordinated to the association 'Souzylneftmash' of the Union Ministry for Oil-Chemical and Oil-Machine Building. After the abolition of the latter in 1989 until the collapse of Soviet Union its plants were incorporated into the Union Ministry for Heavy Machine Building.	<p>12. Baku Building and Construction Material Production Plant;</p> <p>13. Production Association 'Azmetallennirnikimi';</p> <p>14. R&D Association 'Azmetallinvest';</p> <p>15. Production Association 'Tekrarelevanmetal';</p> <p>16. Joint-Stock company 'Azmetallidjaret-Tadkikizat';</p> <p>17. Azerbaijan Scientific R&D Institute of Metallurgy;</p> <p>18. Metallurgia Computer Centre;</p> <p>19. Production Commercial Centre 'Inkishaf';</p> <p>20. Motor Transport Enterprise.</p> <p>The plants of the holding used to produce 70 percent of total oil-field equipment output of the FSU. Azerbaijan has the highest concentration of such manufacturing enterprises in the world, next to the United States. However, the industry was not geared towards the demands of Azerbaijan: only 6 percent of total output was destined for domestic use and important equipment and components required by the local industry, especially offshore, were manufactured in other republics. Due to the system of specialisation within the FSU, the industry is highly dependent on raw materials and intermediary goods from other republics (e.g. as steel production in the country was not geared towards local demands, 90 percent of the required steel has to be imported from Russia or the Ukraine).</p>	Table 4-13). In January 1995 non of the proposed modernisation projects had begun.	Only a small fraction of output was previously exported outside the FSU (about 3 percent). However former clients of other countries of the FSU constitute a huge growing market. The Azeri industry has the advantage of lower costs and larger capacities to its American competitor, which capacity had been heavily rationalised and down-sized in the 1980s. New competition might emerge in other FSU countries particularly from plants of the military complex	Fundamental restructuring investments. Main emphasis is set on obtaining foreign investment in form of joint ventures.

Name	Operating since	Value of assets	Workforce	Subordinated to	Production	State of production facilities and organisation	Potential exports	Required investments
Sabunzhu Machine-Building Plant	1880 by the Swedish Nobel brothers	US\$42 million	650 (3% of which are educated to degree level and above).	Azneftkimyamash State Company	Production of various oil-field and well drilling and exploration equipment for the FSU market (e.g. pumping machines for cold climate zones). Dependent on supplies of raw materials and intermediary goods from other countries of the FSU. Stoppages in productions due to severe disruptions in supplies.	Re-equipment and fundamental modernisation work in the 1980s. Problems of maintenance and repair of equipment. Management would like to establish joint venture with foreign partners. No plans for major restructuring and reorganisation of production sphere, and changes in corporate governance.	which undergo conversion. FSU markets.	US\$2-2.5. Main emphasis is set on obtaining foreign investment in form of joint ventures.
Baku Oil Extraction Machine-Building Plant	1880 by the Swedish Nobel brothers	US\$35 million	800 (14.2% of which have education to degree level and higher, 6.1% specialised education)	Azneftkimyamash State Company	Production of steel and cast-iron slide-valves for oil extraction equipment and pipelines. Important supplier of Azneftkimyamash's Baku Machine-Building Plant named after Satarkhan.	Major investments made between 1986 and 1990 modernising some of the equipment and doubling capacity. Mechanical assembling shops require modernisation. New cast-iron moulding equipment is needed. No plans for major restructuring of production sphere and changes in corporate governance.	FSU markets.	US\$2.5-3 million. Main emphasis is set on obtaining foreign investment in form of joint ventures.
Baku Fahlasu Machine-Building Plant	1900	US\$70 million	900 (14% of which are educated to degree level and higher)	Azneftkimyamash State Company	Oil field equipment (capacity of 3000 rocking machines p.a., constitutes 80% of total production) and other products (e.g. gas propane cylinder tank-trunks for the transportation of liquid gas, construction materials).	No major investments in the last 15 years. Major re-equipment and modernisation required. No plans for organisational changes.	Used to export rocking machines outside of FSU.	US\$4 million to reactivate production. Main emphasis is set on obtaining foreign investment in form of joint ventures.
Baku Machine-Building Plant (formerly named after S. Kirov)	1898	US\$50 million	1000 (19.6% of which have either degree level or specialised education).	Azneftkimyamash State Company	Has a capacity of 600000 sets of locks and connecting ends for drilling and lined pipes p.a.	Major investments in the 1980s. No plans for major restructuring of production sphere and reorganisation. Extension of production to new product lines is planned.	61% of production went to Russia, Turkmenistan, and Belarus.	US\$3-3.5 million to start new production lines. Again, main emphasis set on joint ventures with foreign investors.
Keshla Machine-	1895	US\$40	1500 (28% of	Azneftkimyamash State	Production of various oil field equipment	Partially re-equipped in the	2% of exports have	US\$2.5 million to re-

Name	Operating since	Value of assets	Workforce	Subordinated to	Production	State of production facilities and organisation	Potential exports	Required investments
Building Plant		million	which have either degree level or specialised education).	Company	and parts (capacity of 220 boring sets, 150 units of lifting aggregates and tank-trucks, 270 reduction gears p.a.). Started to manufacture dump-trucks on basis of KAMAZ and ZIL automobiles.	1950s, 1970s, and in 1987-1990. Mainly investments in expansion of lines of production. Plans for partial modernisation. No plans for changes in corporate governance.	gone outside the FSU.	equip and modernise production lines. Again, main emphasis set on joint ventures with foreign investors.
Zabrat Machine Building Plant	1924	US\$14 million	300 (25% of which have either degree level or specialised education).	Azneftkimyash State Company	Production of various oil field equipment and parts (capacity of 300 combined drilling derricks and drilling bases, 200 trailer-cisterns, 500 plunging ploughs for agriculture p.a.).	Partially re-equipped in the 1960s and 1980s. 1440 square meter of empty production areas. No plans for modernisation and reorganisation. Seek joint venture with foreign partner in order to start new production lines.	FSU markets.	US\$2-2.5 million to start new production lines. Again, main emphasis set on joint ventures with foreign investors.
Baku Oil-Field Equipment Plant	1982	US\$30 million	1000 (17.5% of which have either degree level or specialised education).	Azneftkimyash State Company	Production of various oil field equipment and some consumer goods (capacity of 200 pipeline carriers and aggregates for lift servicing, 100 acid aggregates p.a.). Vertically integrated with Russian and Ukrainian producers of metal and automobile chassis.	No plans for major restructuring of production sphere and changes in corporate governance.	FSU markets.	-
Surakhani Machine-Building Plant	1924	US\$100 million	1300 (17.3% of which have either degree level or specialised education).	Azneftkimyash State Company	Production of bar deep pumps (capacity 90000 units p.a.) and various other high precision oil field related equipment and parts.	Ongoing modernisation and work on expansion of product lines since 1984. Capital investment of US\$30 million made in these years.	FSU markets (particularly Russia, Ukraine, Turkmenistan).	US\$20 million for replacement of 20% of equipment. Again, main emphasis set on joint ventures with foreign investors.
Baku Refrigerator Plant	1959	US\$60 million	1500 (29% of which are educated to degree level).	Production Union 'Tshinar'. Which is currently under the supervision of the CMA. This Industrial Association was set up in 1973 and formerly named 'Bakelectrobupribor' until it was renamed to 'Tshinar' in 1988. It used to be subordinated to the All Union	Production of refrigerators (capacity of 400000 units p.a.)	Major modernisation work had been carried out in the 1970s. Large parts of the production facilities had been imported from abroad and are partially automated and computer controlled. It is presently intended to switch the production to conform with non-	FSU markets and systematic export since 1982 to 40 foreign markets (e.g. Algeria, Egypt, Hungary, Laos, Nicaragua, Pakistan, Poland, Turkey).	US\$6.5 million for major re-equipment to conform with new environmental requirements of production.

Name	Operating since	Value of assets ⁹¹	Workforce	Subordinated to	Production	State of production facilities and organisation	Potential exports	Required investments
Baku Machine-Building Plant named after G. Musabekov	1951	US\$8.5 million	30 (half of which are educated to degree level and higher).	Ministry for Machine Building and Light and Food Processing and Industry Household Appliances. However after the abolishing of this ministry it was subordinated to the All Union Ministry for the Electrical Equipment Industry and Instrument Making, until the collapse of the Soviet Union.	Production of machines and parts for light industry (mainly for cotton clearing).	chlorofluorocarbon requirements of the Montreal Convention on the protection of the ozone layer.	FSU markets.	US\$1.5 million to start modernisation process.
Electromashzhiroz	1971	US\$11 million	300 (17.5% are educated to degree level and higher).	Production Union 'Tshinar'.	Production of domestic fireplaces, reflectors, prams and toys made of plastic masses.	Worn out equipment (37.5% of which is used more than 20 years). Needs fundamental modernisation and re-equipment.	Central Asia, Russia, Ukraine.	US\$2-3 million for modernisation.
Bakkkonditioner (BZBK)	1975	US\$4.6 million (BZBK was the only enterprise which provided a balance sheet).	6160 However, many skilled employees have left, especially in the engineering and repairs and maintenance departments. This is a serious problem for the continuity of production.	Part of the 'science-production' association Bakkkonditioner. The so-called 'science-production' associations combine research and development institutes with production facilities and were previously directly subordinated to the relevant Union Ministry. It used to be subordinated to the All Union Ministry for Machine Building and Light and Food Processing and Industry Household Appliances. However after the	The enterprise is a monopoly producer accounting for 100% of total Soviet production, with a total capacity of 430000 airconditioner units. 119000 units were produced in 1994. Except for few component parts the whole production is concentrated in Baku. Raw materials and component parts have previously all been obtained from the FSU. Currently sources are Russia and a number of foreign countries (e.g. Turkey, Iran) mainly via barter system. The barter system restricts sources of supplies. The quality of raw materials obtained through the barter system is low which leads to high scrap levels and	The technology of the equipment and the production processes originated from the Japanese firm Toshiba and is at the same level as similar industrial plants in developed countries. In some production processes the technology is state of the art. However, the majority of machines is 20 years old. There are problems of obtaining spare parts and repairing machines, this is also due to the leaving of skilled workers, who are familiar with the machines and can keep	BZBK has subsidiaries in Alma-Ata, Bishkek, Charkov, Grosny, Kiev, Moscow, Rostov (Don), Samara, Schymkent and Tashkent. Dependent companies are in Ashcabad, Dushanbe, Kishinjow, Machackala, Novosibirsk, Odessa, Pjatigorsk and	-

Name	Operating since	Value of assets	Workforce	Subordinated to	Production	State of production facilities and organisation	Potential exports	Required investments
				abolishing of this ministry it was subordinated to the All Union Ministry of the Electrical Equipment Industry and Instrument Making. until the collapse of the Soviet Union.. BZBK is an independent state enterprise under the direct control of the cabinet of ministers.	variations in final products (e.g. a standard colour cannot be guaranteed for the case). There are extremely good quality control mechanisms. In 1993 15% of the production were done on state orders.	them running, mostly with improvisation and imagination. In the past and presently, spare capacity is used to obtain spare parts, i.e. slowly dismantling these machines. There is no need seen in a change of the enterprise control system. The accounting system in place does not facilitate good internal control.	Tbilisi. Moreover, it maintains service and repair establishments in 77 towns of the FSU (former Soviet Union). Previously Afghanistan, Cuba and Vietnam were major markets. Currently sales are made to Afghanistan, Australia, Belgium, Lebanon, Iran, United Arab Emirates, Bulgaria, Hungary and Pakistan. There is potential for more sales on these markets	
Bakmil Azeri-Italian Joint Venture	1988 (first joint venture set up in the region).	US\$15 million	650 (80% of which have either degree level or specialised education).	Industrial Association Bakconditioner (70% share and) and Marloni Progetti	Production of kitchen electric appliances (capacity of 300 thousand electric mixers, 150 thousand electric mincers, 100 thousand electric coffee grinders, and 300 thousand micro-electric engines p.a.).	Newly set up end of 1980s. State of the art technology with automatic control mechanisms.	FSU markets, Italy, Iran, and other foreign markets .	-
Baku Electronic Computer Plant	1972	US\$45 million	n/a	Used to be subordinated to the All-Union Ministry for the Communication Equipment Industry. Now directly subordinated to CMA.	Used to produce various computer parts. Present production consists of TV sets and radios, and woodworking machines (capacity of 100 thousand black-and-white TV sets and three channel radio sets, several hundred woodworking machines p.a.).	70% of machinery obsolete and worn out. Modernisation and re-equipment required.	FSU markets	US\$5 million for modernisation and re-equipment.
State Bearing Plant	1938	US\$25 million	200 (80% of which have	Used to be subordinated to the All-Union Association for	Production of various bearings (capacity of 30000 p.a.).	50% of machinery is worn out. Fundamental re-equipment and	Previously 75% of production were	US\$10-15 million for modernisation and re-

Name	Operating since	Value of assets	Workforce	Subordinated to	Production	State of production facilities and organisation	Potential exports	Required investments
			either degree level or specialised education).	Manufacture of Pumping Bearings of the All Union Ministry for the Automobile Industry. Now directly subordinated to CMA.		modernisation required.	exported to other republics of the FSU and 15% to foreign markets (including Australia, India, and Korea). Presently 90% of output is exported.	equipment.

Source: Author's transcripts of interviews with the management and employees of the companies and plants, CMA, AME and Centre for Strategic and International Studies staff.

4.2.4 Foreign investment

The early literature on the transition process in PCPEs awaited foreign capital to play a major role in the privatisation process, as foreign investors could provide capital, management skills and modern technology necessary for restructuring (cf. Mann 1991, Salvatore 1993). However, so far foreign investors have committed rather little capital to PCPEs in terms of world-wide foreign direct investment (cf. Lavigne 1995: 162-165; World Bank 1992). The role foreign investment is going to play in the privatisation process in Azerbaijan can be surmised by evaluating foreign investment activities so far.

The economic programmes of the recent years in Azerbaijan all had the strong intention of attracting foreign capital (cf. ARNK 1992, 1993; ARMN 1993). The majority of interviewees pinned their hopes on foreign investments to play a major role in the reconstruction of the economy. However, although a large number of foreign investors have shown interest, overall foreign investment has been low at least until 1994 (see Table 4-13 and Table 4-14). Except for a few subsidiaries and representatives with mainly marketing function, foreign investors have mainly been active in joint ventures.⁹² In 1994 there have been 730 registered joint ventures with foreign direct investment totalling only US\$81.6 million. 33 percent (US\$51.6 million) of total fixed investments were in petroleum-related manufacturing (see Table 4-13). Turkish investors have taken the lead both in numbers (329 joint ventures with Turkish participation) and capital investment (US\$53.9 million) (see Table 4-14). Most joint ventures reportedly exist either only on paper or were not engaging in manufacturing as they had stated and were using tax and import privileges to engage in commercial and intermediary activities (see Table 4-17).⁹³ The majority of the 236 operating joint ventures in 1994 have been small-scale workshops such as bakeries, butcher shops, decorating

⁹² Briefings by AME employees to the author.

⁹³ The law on 'Enterprise Profit Tax' (adopted in February 1992) exempts joint ventures with over 30% foreign participation for two years (or for three years if the enterprise is located in a mountainous region) from profit tax.

firms, catering outlets etc. Presently large scale investments can be only expected in oil extraction in the form of production sharing with international oil companies as mentioned in section 4.2.2 and evaluated below.

The law on 'the Protection of Foreign Investment' was adopted in January 1992 in order to attract foreign investors.⁹⁴ As discussed in Table 4-22 the law has several deficiencies. First, the law provides that nationalisation or expropriation of foreign property could only be carried out in the event of 'damaging popular and state concerns', which leaves room for alternative interpretations. Second, the law guarantees that in case of nationalisation or expropriation foreigners are fully reimbursed. However, implementation mechanisms are not provided. Third, the law prescribes that green field investments have to undergo ecological and health and safety assessments. Again, rules and implementation mechanisms are not provided.

However, the whole legal framework has to be taken into consideration in an assessment of whether the environment is conducive to foreign investment in Azerbaijan.⁹⁵ A survey on investment legislation in PCPEs by the EBRD rated the legislation in Azerbaijan as not very conducive to investment (EBRD 1995: 101-117). The assessment of the EBRD (1995: 103) came to the following conclusion for Azerbaijan:

Legal rules are limited in scope and impose significant constraints on creating investment vehicles, adequate security over assets, or the repatriation of profits.

Legal rules are usually unclear and often contradictory and the availability of independent legal advice is very limited. The administration of the law is substantially deficient (e.g. little confidence in the abilities and independence of the courts, no or poorly organised security and land registers).

Corruption and unreliability of contracts is the direct result of the legal uncertainty. Potential foreign investors questioned about obstacles to foreign engagement saw the volatility of informal payments demanded from various sides as a main problem. The present extreme level of corruption in the entire public

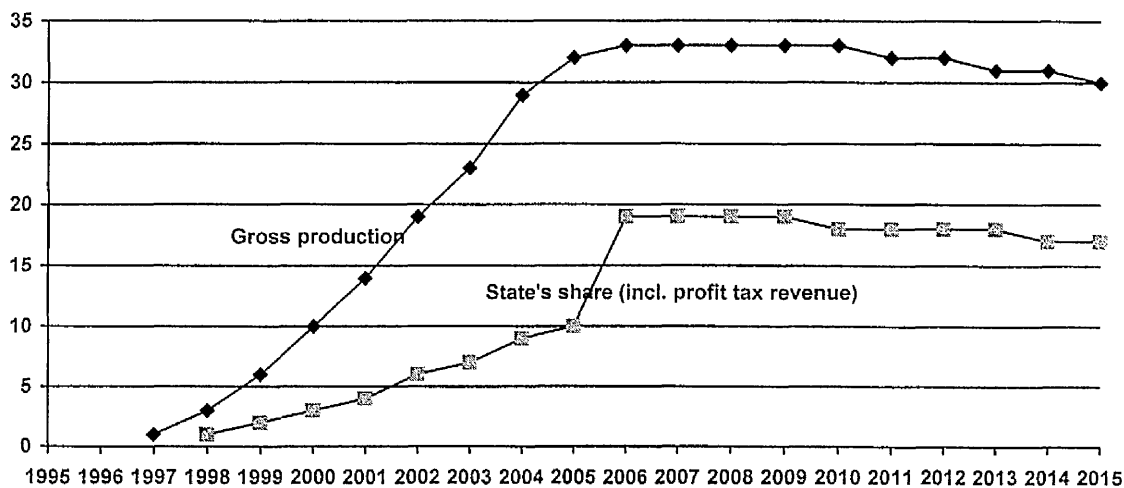
⁹⁴ The law is evaluated in more detail in Table 4-22.

⁹⁵ For an assessment of the legal framework of economic activity in Azerbaijan, see section 4.4.

administration paired with the unreliability of business practices makes even short term cost calculations impossible.⁹⁶

It is therefore not surprising that foreign investment concentrates on the petrol production sharing projects (see section 4.2.2, Figure 4-11, and Table 4-15). Figure 4-11 shows the expected production of the AIOC (Azerbaijan International Operating Company) Consortium, which is exploring and developing the Azeri, Chirag, and deep water Guashli fields in the Azeri section of the Caspian Sea. The state share ranges between 20 percent and 80 percent depending on the world oil price development and transport costs (cf. IMF 1995: 77).⁹⁷

Figure 4-11: Production of the oil consortium
(in millions of tons)



Source: IMF

⁹⁶ The author's experiences in publishing can be taken as an illustration of the business environment of Azerbaijan: in her function as editor of an Azeri research journal the author requested quotations from several Azeri publishing houses for the printing of the journal. It has to be mentioned that none of the publishing houses offered an official price list. She negotiated with one publishing house the price of US\$600 for the print job. One week later, when she actually wanted to collect the printed journal, she was informed that the print job had not been done yet and that it would cost now US\$1,500 to get it done. She went to another publishing house and negotiated a price of US\$900. The journal was printed 6 weeks after the contractual agreed time on paper far below the quality agreed upon. The journal has now a contract with a Turkish publisher. The author can think of many other examples.

⁹⁷ The indicated state share does not include the SOCAR contribution.

Table 4-15 provides the investment, production, profit and total net foreign exchange inflow projection of the AIOC Consortium Production Sharing Contract. The projected total investment amounts to US\$7.5 billion over 15 years with first crude oil exports expected in 1997 (cf. IMF 1995: 77). The second phase of the project involving the development of new fields is dependent on the pre-commitment of a main pipeline route. Total net foreign exchange inflows from the AIOC Consortium Production Sharing Contract will until 2006 be below US\$2 billion and until 2015 around US\$2 billion. There are other production sharing contracts in the pipeline.

Table 4-13: Joint Ventures in Azerbaijan according to branches (April 1994)

Branch	Number of joint ventures	Percentage share	Fixed investments (US\$ mill.)	Percentage share	Azeri share (US\$ mill.)	Foreign share (US\$ mill.)
Agriculture and food processing	90	12.3	9,051	5.79	2,2419	6,8093
Manufacture of basic metals	3	0.4	0.181	0.11	0.1017	0.0800
Machine building and metal processing	20	2.7	3,354	2.14	1,7280	1,6262
Manufacture of electrical machinery & apparatus	21	2.9	6,435	4.12	3,8091	2,6263
Manufacture of motor vehicles	4	0.5	4,045	2.59	2,6237	1,4218
Manufacture of petroleum & chemical products	42	5.8	51,560	33.01	26,2482	25,3125
Healthcare & pharmaceutical products	17	2.5	20,999	13.44	11,8529	9,1466
Manufacture of knitted and crocheted fabrics & articles	21	2.9	0,305	0.19	0,0942	0,2113
Manufacture of carpets & rugs	19	2.6	3,208	2.05	1,5137	1,6943
Manufacture of articles of fur and leather	19	2.6	0,134	0.08	0,0506	0,0840
Manufacture of furniture & wood products	12	1.6	0,0955	0.03	0,0205	0,0347
Manufacture of wooden containers	4	0.5	0,078	0.05	0,0514	0,0257
Consumer goods ¹	282	38.6	8,149	5.21	2,6807	5,4691
Construction & manufacture of construction materials	67	9.2	19,117	12.24	9,4204	9,6971
Transport & communication	32	4.4	21,189	13.56	9,0875	12,1023
Trade & social and personal activities	27	3.7	0,882	0.56	0,1021	0,7804
Marketing & consulting	7	1.0	0,056	0.03	0,0043	0,0525
Tourism services ³	7	1.0	0,603	0.38	0,2450	0,3580
Leasing of machinery & equipment ⁴	3	0.4	0,022	0.01	0,0107	0,0119
Other services	22	3.0	6,280	4.02	2,5071	3,7731
Printing	1	0.1	0,002	0.00	0,0013	0,0014
Electricity, gas & water supply	4	0.5	0,2881	0.18	0,1420	0,1461
Sewage & refuse disposal	1	0.1	0,002	0.00	0,0017	0,0007
Ecological research activity	4	0.5	0,161	0.10	0,0809	0,0804
Total	730	100.0	156,168	100.00	74,6207	81,5482

¹ Small local consumer goods manufacturers² Includes operation of oil and gas fields and service activities incidental to oil and gas extraction³ Activities of travel agencies and tour operators; tourist assistance activities⁴ Not closer specified

Source: AME, own adjustment to the international standard industrial classification of all economic activities

Table 4-14: Joint Ventures in Azerbaijan according to country of foreign partner (April 1994)

Country of foreign partner	Number of Joint Ventures	Fixed Investment (US\$ mill.)	Azeri share (US\$ mill.)	Foreign share (US\$ mill.)
Afghanistan	5	0.012	0.0039	0.0090
Austria	8	0.588	0.3380	0.2509
Belgium	1	0.010	0.0000	0.0100
Belarus	2	0.003	0.0000	0.0033
Bulgaria	4	0.038	0.0101	0.0283
Canada	1	0.006	0.0032	0.0032
China	6	0.446	0.2245	0.221
Cyprus	5	0.181	0.0815	0.0797
Czechoslovakia	4	11.154	5.6882	5.4660
Denmark	1	0.000	0.0002	0.0003
Egypt	1	0.010	0.0000	0.0100
France	4	0.260	0.1062	0.1541
Georgia	2	0.002	0.0002	0.0022
Germany	21	1.114	0.6546	0.4594
Hungary	1	0.010	0.0000	0.0100
India	3	14.152	7.0759	7.0767
Iran	148	2.653	0.9666	1.6866
Ireland	1	0.003	0.0008	0.0026
Israel	6	5.916	3.0073	2.9094
Italy	1	0.015	0.0000	0.0153
Kazakhstan	1	0.000	0.0002	0.0004
Korea	1	0.001	0.0000	0.0016
Latvia	2	0.001	0.0005	0.0007
Lithuania	2	0.060	0.0000	0.0501
Libya	3	0.077	0.0523	0.0248
Malta	2	0.056	0.0287	0.0275
Moldova	1	0.002	0.0000	0.0021
Netherlands	3	0.009	0.0032	0.0066
Norway	2	0.001	0.0004	0.005
Pakistan	2	0.029	0.0140	0.0151
Poland	3	0.018	0.0075	0.0103
Russia	65	1.120	0.2903	0.8304
Saudi Arabia	1	0.070	0.0351	0.0351
Spain	2	0.029	0.0206	0.0094
Sweden	3	0.065	0.0330	0.0271
Switzerland	15	0.363	0.1133	0.2898
Syria	1	0.006	0.0000	0.0066
Turkey	329	108.057	54.1430	53.9140
Ukraine	11	9.014	0.0015	0.0103
United Arab Emirates	6	0.221	0.0763	0.1448
United Kingdom	11	0.239	0.1410	0.0978
USA	38	9.171	1.4883	7.6834
Uzbekistan	1	0.008	0.0000	0.0083
Total	730	156.168	74.6207	81.5482

Source: AME

Table 4-15: The AIOC Consortium Production Sharing Contract: Investment, production, and profit projections

	Unit of measurement	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
INVESTMENT																						
Oil investment	mill. US\$	85	285	640	800	1200	980	994	698	650	579	243	--	--	--	--	--	--	--	--	--	--
of which foreign	mill. US\$	85	285	640	800	1200	980	994	698	650	579	243	--	--	--	--	--	--	--	--	--	--
Imported goods & services	mill. US\$	68	228	512	640	960	784	795	558	520	463	194	--	--	--	--	--	--	--	--	--	--
Bonuses	mill. US\$	143	27	112	28	--	--	91	--	--	--	--	--	--	--	--	--	--	--	--	--	--
PRODUCTION																						
Gross production	mill. tons	--	--	1	3	6	10	14	19	23	29	32	33	33	33	33	33	32	32	31	31	30
PROFIT																						
Pre-tax state share	mill. tons	--	--	0.3	0.8	1.6	2.5	3.4	4.7	5.8	7.3	8.0	14.9	14.9	14.9	14.9	14.7	14.6	14.4	14.1	13.8	13.6
Consortium share	mill. tons	--	--	0.1	0.2	0.4	0.6	0.8	1.2	1.4	1.8	2.0	3.7	3.7	3.7	3.7	3.7	3.6	3.6	3.5	3.5	3.4
profit tax	mill. tons	--	--	0.1	0.2	0.4	0.6	0.8	1.2	1.4	1.8	2.0	3.7	3.7	3.7	3.7	3.7	3.6	3.6	3.5	3.5	3.4
net profit	mill. tons	--	--	0.2	0.6	1.2	1.9	2.5	3.5	4.3	5.4	6.0	11.1	11.1	11.1	11.1	11.0	10.9	10.8	10.6	10.4	10.2
SOCAR share	mill. tons	--	--	--	0.1	0.1	0.2	0.3	0.4	0.4	0.5	0.6	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.0	1.0
Net inflow to the economy	mill. tons	--	--	--	1	2	4	5	7	8	10	11	21	21	21	21	21	21	21	20	20	19
of which state	mill. tons	--	--	--	1	2	3	4	6	7	9	10	19	19	19	19	18	18	18	18	17	17
TOTAL NET FOREIGN EXCHANGE INFLOW	mill. US\$	160	84	280	297	472	557	776	814	955	1157	1197	2148	2148	2148	2148	2127	2106	2085	2043	2002	1962

Source: IMF

4.3 The existing enterprise forms and current governance

As discussed above, in the debate about privatisation in PCPEs de facto property rights and the problem of insider control is widely neglected.⁹⁸ It is generally assumed that the state holds the control rights of its enterprises. However, problems of insider control and spontaneous privatisation have shown, that an understanding of existing property rights given by law or through informal conventions and customs is vital for the discussion on privatisation and enterprise reform. An assessment of existing property rights is central when effects and the process of changes in property rights are examined.⁹⁹ Existing enterprise forms and current governance give important clues on the current position of stakeholders in the contracting process.

In the Soviet command economy, enterprise control was imposed through a highly centralised administrative structure. Besides intentional politically based discretion on the budget constraint of enterprises, the control deficiencies of the centralised, hierarchical Soviet system provided much scope for soft budget constraints to arise.¹⁰⁰ In 1980 the industrial sector was managed by 35 branch ministries (24 all-union and 11 union-republic) which held the de facto property rights of the industries (Schroeder 1992: 222, 224). Only so-called "local" industry (producing goods of local significance, e.g., household goods) were directly controlled by exclusive republic-level ministries (Bahry 1991: 218). Throughout the 1980s several attempts at reform were made under Gorbachev aimed at altering the role of the central ministries, by consolidating ministries, reducing their staff, and introducing new over-arching Bureaux to oversee activities of groups of related ministries. However, inconsistent and contradictory reforms in the industrial sector led to ever larger industrial concentration and weakening of

⁹⁸ For a more detailed discussion of insider control, see section 2.1.2 and 2.3.

⁹⁹ For a theoretical analysis of contracting for property rights, see section 2.1. For an analysis of the process in Azerbaijan, see chapter seven.

¹⁰⁰ The enterprise-control problems of the classical centrally planned economy are well documented in the literature. See for example, Hewett (1988), Höhmann (1981), Kosta (1984) and Wineicki (1988).

central control (Schroeder 1992: 233).¹⁰¹ By the beginning of the 1990s the highly centralised mechanism of enterprise control had gradually disintegrated leaving state organs powerless and individual managers with omnipotent rights of control. By 1991 there had been four enterprise forms in Azerbaijan, discussed below:

- (1) state enterprises (i.e. state companies, concerns, and production unions, also known as associations);
- (2) co-operatives (of producer and consumer type);
- (3) lease enterprises; and
- (4) commercial enterprises (i.e. joint ventures and small enterprises).

Table 4-16 gives details on the distribution of employment between different forms of enterprises. Table 4-17 presents the number and sizes of different forms of enterprises.

Table 4-16: Distribution of employment by form of enterprise in Azerbaijan: 1991-1993 (000s)

	1991	1992	1993
Total employment	2898	2743	2680
State enterprises	1529.3	1128.2	1081
Public institutions	28	25.2	27
Collective farms	332.2	380.1	360
Co-operatives	167.9	130.9	137
Producer co-op.	82.5	49.3	55
Consumer co-op.	85.4	81.6	82
Joint-stock companies	11.2	*	*
Leased enterprises	*	92	95
Joint Ventures	*	2.3	3
Private enterprises	340.5	356.1	358
Private farms	..	2.3	3
Services	340.5	350.8	350
Others	..	3	5

* no data available.

Source: AME

Table 4-17: Number of enterprises according to form (December 1994)

Enterprise form	Number of enterprises		Per unit	
	registered	functioning	average number of employees	average turnover (US\$*)
Small enterprises	24,256	11,391	11	1249
Co-operatives	3,554	1,730	10	576
Leased enterprises	804	718	96	45732
Joint ventures	730	236	26	21595

* US\$ 1 = AzM 4182

Source: ASSC; own calculations.

¹⁰¹ For an account of this period particularly under Gorbachev, see Ausland (1991), Gregory and Stuart (1994: 227-344, 1995: 47-92), Jeffries (1992: 31-39), Hewett (1988), Nove (1989: 379-389), Radygin (1995: 7-19, 27-32), and Schroeder (1992).

(1) *State enterprises*

The all Union law 'on the State Enterprise (Association)' adopted in July 1987 and amended in 1989 showed the way to branch ministries and their republican departments for securing omnipotent control rights over 'their own' enterprises by changing their legal forms into state companies, concerns, associations, etc., also referred to as 'nomenklatura-bureaucratic privatisation'¹⁰² (Radygin 1995: 28).¹⁰³ Immediately after independence of Azerbaijan this process was completed on a republican level, transforming republican departments of all Union branch ministries into some kind of holding company. Nearly all enterprises or industrial units respectively are organised under either state holding companies, concerns, or production unions, also referred to as associations. There are 50 such organisations covering nearly all production spheres of Azerbaijan (see Table 4-18).

All these holdings are subordinated to the CMA. However they hold reportedly de facto property rights over their enterprises. As former nomenklatura members, managers of these holding companies are reportedly well entrenched into patronage networks of the political elite and often themselves hold political posts, e.g. are members of parliament. Accordingly, governance mechanisms of and within these holding structures are blurred, with management and control from the centre not well defined. De jure the governance structure has been determined by the old all Union legislation 'on the State Enterprise (Association)

¹⁰² Radygin (1995: 28) describes the process of nomenklatura-bureaucratic privatisation as follows:

The basic forms found in this type of privatisation are as follows:

- a) 'incorporation' of the branch of industry with the controlling block of shares of enterprises being in the hands of the ministry;
- b) 'concernisation' of the branch of industry: what happens in this case is that the ministry is transformed into a concern with the delegation of rights to it in the area of the management of the state property;
- c) creation of a sectoral association (which is similar to a concern);
- d) delegation of rights to manage state property, including the rights of managing state-controlled blocks of shares;
- e) incorporation of large enterprises, retaining controlling of shares in the hands of the ministry and some other measures.

¹⁰³ For an account of the effects of all Union law 'on the State Enterprise (Association)', see Frydman et al. (1993b: 18-19; 22-23), Gregory and Stuart (1995: 58-59), Jeffries (1992: 32-34), Radygin (1995: 27-29), and Schroeder (1992: 224-226).

until the new legislation was finally introduced in November 1994. However, the new legislation only makes reference to the governance structure of joint stock companies (see Table 4-22). The old legislation had given significant powers to the general meeting of the labour collective, however as reported in interviews, labour collectives have currently little decision power and managerial interests remain predominant in Azerbaijan. The relationship between single managers and the superordinated holding structures can be described as paternalistic. The holding structures protect their enterprises against unstable economic conditions and unwanted reforms and seek rents in the form of indirect subsidies (e.g. cheap credits, inputs etc.). The managers of the holding structures, here termed as an industrial bureaucracy, appear besides enterprise insiders (dominated by managers) as another stake holder in the contracting process.¹⁰⁴

¹⁰⁴ See also section 7.2.

Table 4-18: State companies, concerns and production unions

Branch	State companies	State concerns	State production union
FISHING		"Azərbayc" [fishing]	
MINING AND QUARRYING			
Oil extraction and manufacture of refined petroleum products	SOCAR "Dövlət neft şirkəti" [oil and petroleum products]		
Gas	"Azərgaz"		
MANUFACTURING			
Food products and beverages	1. "Azərbaycanın" [food products] 2. "Təbii məhsulları dövlət şirkəti" [bakery products] 3. "Azərbaycanın" [poultry]		"Bijən" [liquorice]
Wood, wood products (including paper and paper products)			"Azərbaycan" [wood and paper]
Textiles	Azərbaycanın [wool]	"Kənd təsəvvüatı" [Household goods and light industry] ¹⁰⁵	
Chemicals and chemical products	"Azərbaycan"		
Metallurgy	1. "Metallurjiya" 2. "Azərbaycan" [gold]		
Non-metallic mineral products		"Azərbaycanın" [construction materials]	
Machinery and equipment	"Azərbaycanın" [equipment for chemical and oil industry] ¹⁰⁶		1. "Azərbaycanın" [industrial equipment] 2. "Azərbaycanın" [calibration equipment]
Electrical machinery and apparatus			1. "Bakı kondisionerləri" scientific production union [air-conditioner, kitchen equipment] 2. "Azərbaycanın" scientific production union [electrical]

¹⁰⁵ The former Republican Ministry of 'People's Goods' and Ministry of Light Industry merged and renamed themselves into "Kənd təsəvvüatı" concern.¹⁰⁶ 'Azərbaycanın' was set up in April 1993 through the addition of several plants producing equipment for the chemical and refining industries to 'Azərbaycanın' which was solely in the oil equipment field.

				3. "Azərelektrotərm" scientific production union [electrical heating apparatus, furnaces] 4. "Azərelektroishig" [lightening] 5. "Ulduz" scientific production union [radios and television] 6. "Tshinar" [refrigerators]
Furniture			"Azərmebelsənaye" [furniture]	
Other manufacturing			"Khalq üçün mallar" [Household goods and light industry]	1. "İgim" [aviation] 2. "Zərkərsənaye" [jewellery] 3. "NORD" scientific production union [defence] 4. "Azyolmash" [vehicles, including agricultural machinery]
ELECTRICITY			"Azərenerzhii"	
CONSTRUCTION		1. "Azərsənayelikinti" [industry construction] 2. "Azərkəndikinti" [village construction] 3. "Azərtunelmetrotikinti" [metro] 4. "Azəragrartikinti" [agrarian construction] 5. "Azəravtyol" [road construction] 6. "Azərenerzhitikintigurashdırma" [energy sector construction] 7. Azərneqliyyatjolitikinti" [long distance road construction]	1. "Azərkəndütehizat" [water-supply construction in villages] 2. "Azərsutikinti" [water-supply construction]	
TRANSPORT				1. "Azəravtonəqliyyat" [urban, suburban and inter-urban highway passenger transport] 2. "Azərbayjan hava yoları" [airways]
FINANCIAL INTERMEDIATION			"Dövlət sığorta kommersiya şirkəti" [insurance]	
OTHER SERVICES		"Dövlət televiziya və radio verilişləri şirkəti" [broadcasting]	1. "Xidmət" [services] 2. "Dövlət sənaye-ticarət konsemləri" [trade of industrial goods]	1. "Azərbkharitijarət" [foreign trade] 2. "Səngkharitijarət" [foreign Eastern trade] 3. "Azərkinovideo" [motion pictures] 4. "Azərməhzilkompliklayitələmir" 5. "Orbita Servis" (Television)

Source: AME; Author's research.

(2) *Co-operatives*

According to Table 4-17 there have been 3,554 co-operatives registered in 1994, of which 1,730 were actually functioning and operating on a very small scale. Co-operatives accounted for 6% of total employment (167,900 employees) in 1991, which fell to 5% (137,000 employees) in 1993 (see Table 4-16).

51% of all employees working in the co-operative sector were employed in so-called consumer co-operatives. In 1993 the latter accounted for 60% of employment in co-operatives (see Table 4-16). Consumer co-operatives had already been a familiar feature in Soviet times. They were limited to agriculture and consumer services, however, little resembling co-operatives in the profit and decision power-sharing sense (cf. Frydman et al. 1993b: 26). The formation of producer co-operatives was only allowed in the late 1980s by the all Union law 'on Co-operatives', enacted in June 1988, and amended in 1989 and 1990 (Frydman et al. 1993b: 26). Producer co-operatives were reportedly mainly established within state enterprises making use of their assets and inputs, and can be regarded as a form of spontaneous privatisation (cf. Radygin 1995: 10). The all Union law 'on Co-operatives' which was still in force in 1994 in Azerbaijan, made governance provisions involving a general meeting of members, with a one-person-one-vote rule regardless of contributions, deciding upon all major questions (e.g. election of executive body, charter amendments, etc.) (Frydman et al. 1993b: 26-27). However, producer co-operatives in Azerbaijan reportedly resemble far more the classical owner-manager firm. However, producer co-operatives in Azerbaijan employed only two percent of the total workforce in 1993 and are, therefore, of little significance (see Table 4-16).

(3) *Lease enterprises*

Lease enterprises are another development of the late 1980s and early 1990 and constitutes the most popular form of insider privatisation (Radygin 1995: 11). Leases were reportedly nearly always assigned to insiders and the respective enterprises are mostly operating within the framework of the subordinated holding structure. There have been 804 registered leased enterprises in 1994 of which 718

were functioning (see Table 4-17). Leased enterprises are significantly bigger than co-operatives with an average of 94 employees (see Table 4-17).

(4) Commercial enterprises

There are presently three kind of commercial enterprises operating in Azerbaijan: (1) small private enterprises (mostly in the trade and service sector), (2) joint stock companies, and (3) joint ventures. Small enterprises had already been promoted in the Soviet period (cf. Schroeder 1992: 223). There has been considerable thought directed towards the promotion of small and medium sized enterprises by the policy makers in Azerbaijan. In 1992 the National Small Enterprise Support Fund was set up under the State Committee on Anti-monopoly Policy and Support for Entrepreneurship.¹⁰⁷ In January 1993 a 'State Programme on the Development of Entrepreneurship in Azerbaijan' was passed by parliament. However, small enterprise development is a difficult process under the given institutional inadequacies. In 1994 there have been 24,256 registered small enterprises of which only 11,391 were operating (see Table 4-17). Sixty percent of functioning small enterprises have been operating in the trade sector (see Table 4-19).

Table 4-19: Functioning small enterprises according to branches (December 1994)

Branch	Number of enterprises	Percentage share
Industry	1,594	14
Agriculture	797	7
Construction	912	8
Trade	6,835	60
Other branches	1,253	11
Total	11,391	100

Source: ASSC

Table 4-20 presents the volume of production of important goods in small enterprises. Small enterprises have a significant market share in the production of reinforced concrete, textiles, and wine.

Table 4-21 displays the list of joint stock companies registered in 1994. Most joint stock companies were established before independence. The majority are owned by state enterprises or directly by nomenklatura members and are

¹⁰⁷ See ARDASSKK (1994 a, b, c, d).

engaged in trade and services (see Table 4-21). The existing joint ventures are only small operations run by their immediate owners and bear no resemblance to western joint stock companies. New legislation on joint stock companies was only passed in July 1994 and has been in force since November of the same year (see Table 4-22).

Table 4-20: Production of important goods in small enterprises (December 1994)

Good	Unit of measurement	Production	Percentage of total production
Oil equipment	US\$**	3211	0.4
Cement	tons	12,500	3.2
Stone-bricks	thous. Units	900	*
Bricks	thous. Units	400	0.9
Ashlar-bricks	thous. sqm	23.8	6.4
Reinforced concrete	thous. m ³	600	34.6
Sanitary ceramics	thous. units	400	1.3
Paint	tons	354	*
Footwear	thous. units	56	1.9
Knitted fabric	thous. units	50	0.3
Hosiery	thous. units	98	0.5
Jackets	units	7,348	29.2
Clothing	thous. units	56	33.8
Meat	tons	1,180	15
Sausages	tons	179	5.7
Tins of food	thous. units	1,664	1.2
Wine	thous. decilitres	253	22.2

* no data available

** US\$ 1 = AzM 4182

Source: ASSC; own calculations.

Table 4-21: Joint-stock companies in Azerbaijan in 1994

<i>Name</i>	<i>Description</i>
1. İnsan	Trade.
2. Inter-Art-Prakson	Scientific research, scientific-technical projects.
3. J. & A. Korporasiya	Trade.
4. Türan	Trade.
5. Khäsär	Construction and Transport equipment manufacturer.
6. Azerb. Maliyyä Shirketi	Financial services.
7. Azerb. Investisiya Shirketi	Financial services.
8. Enerzhigurashdırma	Technical installations and repairs.
9. Audit-Brok-Servis	Commerce.
10. Azərbaycan Sənaye Ticarät Evi	Commerce, brokerage.
11. AVVA-Kedr	Commerce.
12. Kaspian	Trade.
13. Bırzhalararasıj Broker İttifagı	Trade.
14. Bakı-Mos-Audit	Legal services and trade.
15. AZ.CTK Ticarät Evi	Trade.
16. Azer-Beyt	Tourism.
17. Eleks Birliyi	Carpets, textiles, shoes, and construction material production.
18. Sovin	Trade and technical services.
19. Khäbär-Servis	Printing and publishing.
20. Azsilikol	Metal processing and trade.
21. Arzy	Trade.
22. Fantaziya Kommersiya	Construction materials, technical services, and tourism.
23. Yenilik	Commerce.
24. ARKO	Construction and refurbishment.
25. Küral	Marketing, trade, and tourism.
26. Azerenerzhimanziltikinti	Commerce and construction materials.
27. Azgür	Construction.
28. RAR	Trade.
29. Azerbaychan-Sputnik	Tourism.
30. Resüloğlu İstehs. Korporasiyası	Commerce and construction materials.
31. Bakssj	Insurance.
32. Tajir-Ticarät Evi	Trade.
33. Şimali Azärbayjan	Commerce and technical services.
34. Azärbälvanmetaltijarättäjhizat	Trade.
35. İnformatika Elmi-Tekhniki Kompleksi	Scientific-technical consulting.
36. İnje LTD	Commerce, construction and refurbishment.
37. Azneftmash	Trade, commerce and machine parts production.
38. Kenje	Trade and tourism.
39. İ V M	Commerce.
40. Şäfa	Commerce.
41. Nermine	Commerce, construction and refurbishment.
42. FDS	Commerce.
43. Taleh İstehsal-Kommersiya Firması	Commerce.
44. ATRA	Commerce, trade, and refurbishment.
45. Sparkmeng-Star	Trade.
46. Eherşhitekhyenileşdirme	Commerce and saddle maker.
47. BEKS	Trade and Construction.
48. FORT-İnfo-İnk.	Commerce, marketing and exhibition organisers.
49. Karşhı İnterneshnal İmport End Export İnk. Bakı	Trade and marketing.
50. Elmar-Garant	Insurance.
51. ANS	Commerce and freight forwarder.
52. ELS-AZAL-Express	Transport, commerce and construction material production.
53. Elmarbank	Banking.
54. Khäzri	Trade and banking.
55. Hidrokhüsüsitikinti	Unknown.
56. ARANS	Unknown.
57. Rüzübank	Unknown.
58. Azintür	Unknown.
59. İnşhan	Unknown.
60. Arkha	Unknown.
61. Azerb. Halg Birşhası	Unknown.
62. Atash	Unknown.
63. Şhärğ-Gärb	Unknown.
64. Azlitbalkan	Unknown.
65. Türkan Korporasiyası	Unknown.
66. Azturkmetal	Unknown.
67. Cavalan Firması	Unknown.

Source: Supreme Soviet of Azerbaijan; and author's investigations.

4.4 Legal framework for economic activity

The legal framework provides the formal rules for economic activity and its formation is a vital part of the institutional preconditions for an effective market environment. Particularly for the newly emerging private and quasi-private sector, and hence successful formal privatisation, legal rules must be in place to minimise market failure and to alleviate the uncertainty in long-term investment. However, first experiences in PCPEs have shown that the bare adoption of laws does not guarantee their *de facto* use (cf. EBRD 1995: 101-117).¹⁰⁸ Thus the emphasis purely on the drafting and adoption of legislation is not adequate, as inaccessible and poorly administered and enforced rules are ineffective.¹⁰⁹

Table 4-22 provides an evaluation of the status of major legislation for economic activity in Azerbaijan.

The legal framework has to be assessed on three levels:

1. the drafting and accessibility of laws, i.e. whether laws are clear and predictable, whether they are suitable for the local context, and whether they are widely disseminated;
2. effective administration of laws, i.e. clear allocation of responsibilities to different executive organs (e.g. police, prosecution services, tax inspectorate etc.), effective co-ordination between them, and sufficient funding;

¹⁰⁸ Most consultants who were appointed to assess the legal environment in Azerbaijan concentrated on whether important laws existed and rarely checked whether they were *de facto* implemented.

¹⁰⁹ International organisations often tried to assist the legislature by paying expensive foreign consultants to support the preparation of laws. Besides problems arising from lack of knowledge of given institutions in the host country, there have been extreme language problems in the newly independent states of the FSU. Laws are drafted in the new official languages of the respective countries whilst there are no international lawyers who actually command these languages, particularly the legal terminology. There are hardly any specialist legal translators for these languages, only for Russian. The majority of the population cannot comprehend legal terminology. Azeri Turkish can at least be understood with a knowledge of Turkey Turkish. Legal terminology is derived from Farzi and Arabic and is very similar to the Turkey Turkish usage. However Kazakh, Usbek and other Turkik languages can only be comprehended on a very basic level.

3. effective judicial enforcement of laws, i.e. well funded and financially and politically independent judiciary, which effectively incorporates new legislation.¹¹⁰

As indicated in Table 4-22 the Azeri legal framework embodies grave deficiencies on all three assessment levels. Concerning the first level, there is considerable uncertainty whether old all Union legislation is still in force in cases where new Republican legislation is less comprehensive. Further, uncertainty arises as wide discretion is granted to the president, the prime minister, and the ministers to modify rules without prior consultation by way of executive decree. Moreover draft laws are hardly made public. Thus various stakeholders (e.g. administrative agencies, courts) have no opportunity to include their comments.

Concerning the second assessment level, laws are not effectively administered as there is neither a clear demarcation of responsibilities between the various arms of the executive (e.g. police, prosecution services, tax inspectorate etc.) nor an effective co-ordination between them. The executive bodies are all poorly funded, regarding both personnel and infrastructure. There are reportedly power struggles between different executive bodies to gain more control over certain responsibilities (e.g. tax collection) as these grant higher informal income. The different executive bodies seem to be preoccupied with informal income generation.

Concerning the third assessment level, the judiciary is poorly funded, which critically reduces effective judicial enforcement of laws. However, it is still too early to assess the judicial enforcement of laws as there is no track record of judicial decisions in business disputes etc. So far the co-ordination between the courts and executive bodies like the police and the prosecution services is reportedly poor.

¹¹⁰ These criteria are also used by EBRD (1995: 101-107) for the evaluation of how conducive the legal framework is to foster investment.

Table 4-22: Status of legislation on economic activity (February 1995)

Legislation	Status	Date adopted/ amended	Comments	Accessibility and enforcement
Constitution	Draft law	Pending	The old constitution of 1978 supplemented by the Declaration of Independence and a new constitution is at draft stage. Due to Soviet legacies the separation of power between legislative and executive branches of government is blurred, with all important decisions being taken both by the Presidential Apparatus and by the Council of Ministers. The Presidential Apparatus, the legal committee of the Parliament, and the CMA are drafting new legislation - often independent from each other.	Draft constitution has not been made public and was difficult to obtain.
Civil code	No new legislation	-	Old all union legislation still in force.	-
Commercial code	No new legislation	-	Old all union legislation still in force.	-
Business Laws Contract law	No new legislation	-	As mentioned above, the old all union civil code is still in place. The latter is an inadequate basis for contractual arrangements. E.g. rights and duties of contractors are not defined, and there are no provisions for legal consequences of a breach of contract.	-
Property	New legislation	December 1991	Definition of property includes land, enterprises and intellectual property. Distinguishes between state, collective, and private property, however without defining rights and duties of individual members of a collective, which is a source of discretion for insiders. The law restricts property rights and reserves the state the right on expropriation through references to other unspecified laws, which causes uncertainty and latitude for bureaucratic discretion to confiscate property.	Lack of secondary laws. Poorly funded judicial system and police. Lack of co-ordination between various arms of state (e.g. prosecution services, police, courts). No adequate system of public registers for shares and other security interests (e.g. mortgages, liens). No effective land cadaster. High fees (often informal) for notarisation.
Intellectual Property	No new legislation	-	New legislation required complying with international standards.	-
Entrepreneurship	New legislation	15 December	Declares acceptance of different entrepreneurial activities and state protection and	No adequate registration system.

Legislation	Status	Date adopted/ amended	Comments	Accessibility and enforcement
Company law 'On Enterprises'	New legislation	1992	encouragement of the latter. Entrepreneurs are required to register and some activities (listed by the parliament) require a special licence.	
		1 July 1994 (in force since 22 November 1994)	Determines organisational and juridical forms of enterprises. Special licences must be obtained for activities defined by the Parliament. The law distinguishes between the following organisational and legal forms of enterprises: (1) state companies, (2) individual (family) enterprises, (3) general partnerships, (4) limited partnerships, (5) limited liability companies, (6) joint-stock companies (of open and closed type). No clear demarcation of different organisational and legal enterprise forms. Enterprises can form unions, firms, concerns and other associations in compliance with the anti-monopoly legislation. No clear definition of different forms of associations and their status. The association is not responsible for obligations of the constituent enterprises and vice versa, unless its charter states otherwise. Any enterprises form except for state-owned and individual-owned enterprises have to draw up a charter approved by the formation meeting or by the founder. Incomes of non-registered enterprises, establishments, and organisations can be withdrawn for the local budget. Liquidation is performed by the liquidation commission of the owner or authorised body, or in case of bankruptcy, in compliance with the court of arbitration. Law provides rudimentary bankruptcy provisions. Law provides rudimentary corporate governance provisions, however they lack secondary laws, e.g. accounting standards and disclosure rules.	Lack of secondary laws (e.g. disclosure and accounting standards, fiduciary liability etc.) Activities which require a licence had not been defined by January 1995. Lack of an adequate administrative body which could administer these licences effectively. High fees (informal) can be expected for licences. There are complaints about delays and about corruption in the enterprise registration. Anti-monopoly legislation is not effective.
'On Joint-Stock Companies'		12 July 1994 (in force since November 1994)	The law distinguishes between two forms of joint-stock companies: (1) the open type (i.e. shares may be issued to the public and can be traded without restrictions) and the closed type (i.e. shares cannot be sold without consent of majority of shareholders, and thus not openly traded). There are ordinary and non-preference shares. The governing bodies defined are the shareholders' meeting, the board of directors, the governing board, and the auditing committee. Shareholder meeting has exclusive rights to increase and decrease the authorised capital, elect directors, confirm annual report, decide to open or close branches, to liquidate the company (3/4 majority required), and to alter the charter (3/4 majority). 60 percent of the shareholders with a right to vote have to be present in order to take decisions. Unless the charter states otherwise, shareholder meeting have to be held once a year. Holders of a minimum of one-tenth of the authorised capital can demand a shareholder meeting and the board has to comply within 30 days. If the board fails	See above.

Legislation	Status	Date adopted/ amended	Comments	Accessibility and enforcement
Foreign Investment	New legislation	January 1992	<p>to meet these demands, shareholders can appeal to court. There is no adequate mechanism for minority shareholder protection in place. There are no sufficient provisions made for corporate governance: (1) no provisions for management contracts, (2) no mechanisms for dismissal of directors through shareholders, (3) no independent mechanisms to decide upon salaries and benefits for directors, and (4) no prohibition of loans and non approved benefits to directors and connected persons.</p> <p>The law guarantees rights of foreigners to (1) establish fully or partially owned enterprises; (2) acquisition of enterprises, buildings, shares, bonds, and other securities; (3) use land, and other natural resources; (4) participate in privatisation of state municipal enterprises and unfinished constructions. Foreign investment activity cannot be less favourable than that for property rights and investment activity of Azeri juridical entities. Provides that in case of changes of foreign investment legislation, the foreign investor is dealt with according to legislation of the moment of investment. However, this does not concern legislation on taxes, credit and finance, environmental protection, etc., which considerably reduces the value of the latter provision. The act guarantees repatriation of profits, and that in case of nationalisation or expropriation foreigners are fully reimbursed, including lost benefits. However, there are no set implementation mechanisms. Foreign investment cannot be nationalised or expropriated except for events of 'damaging popular and state concerns', which is fairly unspecified. Green field investments have to undergo ecological and health and safety assessments. Registration procedures and documents required are determined by the Council of Ministers. Foreign investors are guaranteed privileges in export and import.</p>	See above.
Leasing activity	New legislation	November 1994	Provision of supporting legislation and schemes and rules required.	
Lease	New legislation	April 1992	Provision of supporting legislation and schemes and rules required.	
Bankruptcy	New legislation	Adopted 22 July 1994 was not in force by January 1995	State-owned 'special' enterprises, budgetary organisations, public utilities (except for commercial ones), organisations and enterprises without income are not subject to bankruptcy. No emphasis of restructuring and protection of assets which would be adequate for the restructuring period. There are provisions made for out-of-court	Shortage of judges, qualified trustees and liquidators. Considering also the poor development of the legal

Legislation	Status	Date adopted/ amended	Comments	Accessibility and enforcement
			settlements, however without special schemes and rules prescribed or regulated in secondary laws.	periphery and of capital markets, it will take a long time before clear and binding rules and procedures for the exit of firms are established.
Pledge	No new legislation	-	Provision of legislation and schemes and rules required.	-
Employment	No new legislation	-	Old all union legislation still in force.	-
Consumer protection	No legislation	-	New legislation required.	-
Auditing Services	New legislation	September 1994	Provision of schemes, rules and professional bodies required.	-
Insurance	New legislation	adopted January 1993	-	Not publicised, not enforced.
Regulation of monopolistic activity	-	Pending	-	-
Unfair competition	-	Pending	-	-
Agriculture				
Land Code	New legislation	December 1991	Conditions land property rights.	Lack of corresponding legislation and administrative measures.
Agrarian Reform	-	Pending	-	-
Sovkhoz and Kolkhoz reform	-	Pending	-	-
Taxation				
Personal income tax	New legislation	June 1992	Progressive income tax.	-
Enterprise profit tax	New legislation	February 1992	Progressive rates; special rates for certain activities (e.g. joint ventures, co-operatives etc.).	-
Legal entities' income and profit tax	New legislation	December 1991	-	-
Value-added tax	New legislation	January 1992	Maximum 20 percent	-
Excise tax	New legislation	December 1992	Applicable to a list of goods.	-
Oil production royalties	New legislation	January 1993	Differ by source of oil; changing.	-
Customs committee	New legislation	June 1992	Own customs duties; changing	-

Legislation	Status	Date adopted/ amended	Comments	Accessibility and enforcement
Social Security contributions	New legislation	January 1993	Employer and employee contributions to Social Protection Fund and Employment Fund.	-
Land Tax	New legislation	January 1993	Land tax varies according to region, location, quality, and water supply, and form of cultivation.	-
Enterprise Assets Tax	No new legislation	Pending	-	-
Excess profit tax	No new legislation	Pending	-	-
Gift and inheritance taxes	No new legislation	Pending	-	-
Financial infrastructure				
Currency regulation	New legislation	October 1994	Two potentially conflicting objectives: (1) ensuring currency stability, (2) uphold the interests of the state.	Inadequate corresponding regulations (e.g. prudential regulations), enforcement power, and administrative measures.
National Bank	New legislation	August 1992/ amended February 1993	No restrictions on activities; banks can act as universal banks.	
Banks and banking activity	New legislation	August/ amended February and March 1993		
Securities and stock exchange	No new legislation	Pending	-	-

Source: Author's law reviews and interview transcripts.

4.5 The financial infrastructure

Azerbaijan is still in the early stages of the development of sound banking institutions. The legal foundations for a two-tier banking system were only laid in August 1992 with the law 'On the National Bank in the Republic of Azerbaijan' and the law 'On Banks and Banking Activity in the Republic of Azerbaijan' (see Table 4-22). In 1994 the banking system in Azerbaijan consisted of the Azeri National Bank (ANB), four specialised state banks (Agroprombank, Prominvestbank, Amantbank (formerly Sberbank), and the International Bank (formerly Vneshekonombank)), five banks with foreign participation (Turkey and Russia), one branch of a foreign bank (Milli Iran Bank), and 149 commercial banks (see Table 4-23).¹¹¹ Until 1995 there have been considerable difficulties with domestic and interstate interbank settlements. Domestic commercial banks used to settle their payments directly between themselves through mutual accounts, mostly held at Prominvestbank or Agroprombank, respectively (cf. IMF 1995: 18).¹¹² The latter settled their claims between each other only once a year, extending credits automatically to each other. Interstate settlements were complicated with the break down of the all Union settlement system in 1992. Payments between states of the FSU relied on interstate agreements often, however, without providing clear clearance mechanisms (cf. IMF 1994: 19).

Table 4-23: The banking system of Azerbaijan (July 1994)

<i>Type of bank</i>	<i>Number of banks</i>	<i>Authorised capital (million rouble)</i>
Azeri National Bank	1	
Specialised state banks	4	7482
comprising:		
Agroprombank (Agricultural Production Bank)	1	2863.3
Prominvestbank (Industrial Investment Bank)	1	3911
Amantbank (Savings Bank, formerly Sberbank)	1	390.3
International Bank (formerly Vneshekonombank)	1	317
Commercial banks	155	26428.8
including:		
Azakbank		1118.6
Banks with foreign participation (Turkey, Russia)	5	963.4
Branch of foreign bank (Milli Iran Bank)	1	118.6

Source: AME

¹¹¹ The information of the following section is based on the author's transcripts of interviews with AME, AMF, and bank staff.

¹¹² The settlement system used was modelled after the former all Union payment system named after its Russian acronym MFO (IMF 1995: 18).

The ANB, empowered with central bank and commercial bank supervision functions, was created in February 1992 through the merger of the Azeri branch of the USSR Gosbank and parts of the Agroprombank and the Prominvestbank. However, until 1995 the ANB had obtained little independence and enforcement power. First, its monetary policy had to be approved by parliament. Second, international reserves have been directly managed by the government, first in several foreign exchange funds and since April 1994 in the Consolidated Foreign Exchange Fund, comprising the currency stabilisation fund. Third, ANB had little control over the four specialised state banks, which had not even been subject to reserve requirements until January 1994. Fourth, supervisory functions were flawed by inadequate prudential regulations and lack of both human resources and administrative measures (see Table 4-24). Fifth, government agencies have been able to draw upon unlimited credit lines (cf. IMF 1995: 18).

Table 4-24: Prudential regulations for the banking system (May 1994)

Regulation	Content	Enforcement
Minimum authorised capital requirement	<ul style="list-style-type: none"> AzM 100 million for new banks (equalled US\$100,000 in May 1994). AzM 30 million for existing banks (equalled US\$30,000 in May 1994). 	High compliance.
Reserve requirements	<ul style="list-style-type: none"> 12% AzM deposits. 5% foreign currency deposits. To be held at the ANB. 	Low compliance.
Capital adequacy ratio	<ul style="list-style-type: none"> 8% 	Low compliance.
Minimum assets-to-liabilities ratio	<ul style="list-style-type: none"> 50% for a maturity up to one month. 30% for a maturity between one and six months. 20% for a maturity between six and twelve months. 	Low compliance.
Limits on large exposures	<ul style="list-style-type: none"> Maximum risk exposure to a single borrower may not exceed 50% of a bank's own funds. No total large exposures portfolio limit. 	Low compliance.
Limits on equity investments	<ul style="list-style-type: none"> A bank's investment in the capital of non-financial enterprises is limited to an amount equal to 10% of the bank's own equity. 	Low compliance.
Classification of non-performing assets	<ul style="list-style-type: none"> None, due to lack of accounting standards. 	-

Source: Author's transcripts of interviews with bank employees.

Monetary policy in 1993 and 1994 was dominated by fiscal debt financing and indirectly subsidising state enterprises through credits at negative interest granted by the specialised state banks (cf. IMF 1993, 1994, 1995). Until 1995 bank credit was still granted administratively, setting interest rates on a case-by-case basis. Throughout 1993 and 1994 deposits were often non-convertible due to shortage of banknotes.

The specialised state banks had been until December 1991 regional branches of their corresponding all Union state banks, supervised by the all Union Gosbank. As such they had little decision making power and were merely implementers of central directives and, in case of the Sberbank, depositories of private savings. After independence these formerly regional branches had taken up full bank functions, but they continued operating in their old fields. The International Bank has almost a monopoly on dealing with foreign currency transactions. The Amantbank (formerly Sberbank) is concentrating on household deposits. The Agroprombank and Prominvestbank remained closely linked with state enterprises or their holding structures respectively, to which they are the major lenders with little incentive to impose hard budget constraints. According to the IMF (1995: 18) both banks had de facto unrestricted access to central bank credit. In 1994 all specialised state banks accounted for more than 80% of total lending and deposit activities (cf. IMF 1995: 17).

The first commercial banks were already set up in Soviet times under licences from the former all Union Gosbank and the largest, the Azakbank, was established in March 1991 as a joint stock company with 50% private capital participation. The majority of the 155 commercial banks are operating on a very small scale and are set up by state enterprises. In 1994 all commercial banks accounted for less than 20% of total lending and deposit activities (cf. IMF 1995;17).

By 1994 there have been no active investment funds and no Stock Exchange. The only non-bank financial institutions operating have been the so-called charity organisations which offered interest rates on household deposits up to 30% per month and provision of cheap imported goods for their 'members'.¹¹³ These organisations profited from inflation which, before the AzM was fixed against the US\$, was reflected in a constant fall of AzM against US\$. They converted their AzM deposits into US\$ with which they financed their informal imports of food and cheap consumer goods mainly from Turkey, Iran, FSU states and Dubai. According to IMF (1995: 21), at the end of 1994, households held nearly as much in deposits at these institutions as in the entire banking sector. Many people in Baku sold their entire possessions in order to invest in these organisations and lived off their interest payments. However,

¹¹³ The most widely known charity organisation has been the Vagifbank.

the charity organisations crashed after the AzM was fixed against the US\$, and they became unable to pay these huge interests, with all the investors losing their investments.

4.6 The limitations of government

Most PCPEs are left with seemingly insurmountable legacies which improve only gradually: weak states dependent on their patronage networks for survival; political parties and organisations that are unrepresentative and lacking a mass popular base; industrial sectors characterised through monopolies, excess capacities, low profitability, environmental pollution, and increasing technological obsolescence; inefficient and wasteful agricultural production; overcrowded and to a great deal obsolete bureaucratic structures; etc. Political and economic reforms are not merely required to maintain the status quo, but to stop the free fall of the economies and prevent political chaos.

The role of the state in these transitional economies is to set and enforce a far-reaching reform agenda aimed at overcoming the institutional inadequacies and at realising massive industrial restructuring. However, this requires traditionally weak states to challenge powerful interest groups on which they rely for their survival.

Historically, states have used political ideologies in order to win over various interest groups to follow their objectives. At the beginning of the transition period these superordinated goals have been the establishment of a market economy often paired with nationalist sentiments. However, five years on, the allure of the market system has faded.

Azerbaijan like many other newly independent states of the FSU has not embarked upon the path of transition by choice. There has not been a mass movement, as in Poland and the GDR, actively pursuing systemic changes. The pursuit of political independence from Russia and the defence of the Azeri territory against Armenian/Russian attacks only gained relatively short-lived mass support. However, political power struggles of the past years and the defeat in the Karabagh war have caused political apathy and wide disillusionment in the population. The relative political stability under President Aliiev is only maintained through massive concessions to the old nomenklatura. As mentioned above, the last years have

witnessed a decay of the state apparatus allowing ministries and other executive organs to be developed into little thieftedoms pursuing their informal income generation. The dominance of the old nomenklatura in the political and economic arena has remained unchallenged. Section 4.3 has shown that the nomenklatura has understood the role of safeguards against unwanted changes by creating and maintaining huge holding companies.

Any reform proposals in Azerbaijan have to take into account that the very groups whose interests are challenged through reform programmes conducive to enhanced static and dynamic efficiency, are those on whom the state relies for survival. And reforms have to be carried out by officials whose own jobs and sources of rent extraction are at stake.

Concluding remarks

To summarise: the evaluation of the institutional background has revealed very unfavourable conditions for privatisation. First, the political setting is characterised by internal power struggles, decay of the state apparatus with corruption becoming a pervasive phenomenon, and the Nagorno-Karabagh conflict. President Aliiev has contrived to introduce some internal stability and negotiate a cease-fire. However, in order to guarantee long-term political stability, (1) constitutional changes are urgently needed, (2) the public administration requires thorough restructuring according to the new needs of the economy, and (3) the cease-fire in Nagorno-Karabagh including the related displaced persons issue need a more permanent solution. On all three points little progress has been made so far.

Second, the economy has been in a free fall for the past five years with the gap between petroleum related activities and other industrial activities widening ever more. Large parts of the industrial capacity have ceased production and are exposed to asset stripping and decay. A massive restructuring effort has to be made in order to revive industrial production.

Third, the industrial structure is highly concentrated with nearly all enterprises or industrial units, respectively, organised under 50 state holding companies, concerns, or production unions, also referred to as associations. Corporate governance

is characterised by pervasive insider control paired with ill-defined paternalistic relations between individual enterprises and their superior quasi-holding structures.

Fourth, the legal framework embodies grave deficiencies regarding the drafting and accessibility, effective administration and judicial enforcement of laws.

Fifth, banking institutions are still in the early stages of development, and there are no active non-bank financial institutions nor security markets and instruments.

Sixth, the agenda setting power of the state in the reform process is very limited, due to its extreme dependence on its patronage networks for survival.

5. Plans and realities of privatisation in Azerbaijan

Introduction

In chapter four, a critical assessment has been made of the institutional background to privatisation in Azerbaijan. This chapter is concerned with an overall evaluation of the proposed approach to, and process of, Azeri privatisation.

Azerbaijan was one of the last republics of the FSU to adopt a law on the privatisation of SOEs. The privatisation legislation consists of the main privatisation law, the implementation of which requires the formulation and adoption of annual privatisation programmes. The latter are prepared by the ASPC, the body responsible for privatisation. A draft for the first of such programmes was submitted in March 1993. However, it failed to obtain parliamentary approval. A revised draft programme was submitted to parliament on 28 April 1994 by the President. However, it too had failed to gain approval by the end of the field study period.

Privatisation in other sectors has been also slow. In the agricultural sector, privatisation and general reform will be determined by the law 'On the Principles of Agrarian Reform' and the law 'On Sovkhoz and Kolkhoz Reform', which had not yet been passed by January 1995. The land code passed in November 1991 never came into effect because of lack of legislation supporting its implementation. As preparatory work for the land reform, the State Land Committee was entrusted with the preparation of an inventory of all agricultural units. The work had not been completed by January 1995. The new laws 'On the Principles of Agrarian Reform' and 'On Sovkhoz and Kolkhoz' had been in preparation for almost three years. Even if they are eventually passed, additional legislation has to be prepared, clarifying the mechanisms of implementation, regulation and control.

A law regulating the privatisation of housing was passed by the end of 1993. Ownership of houses was transferred free of charge to their registered occupants. Further, the majority of the 7,000 strong taxi-cab fleet was privatised by presidential decree in mid-1994. Officially, prices were to range from 30,000 to

150,000 (US\$75 to 370 according to the market exchange rate in May 1994).¹ Half of the official revenue raised went to the state budget and half to the former Ministry of Road-Transport which has converted itself into a 'concern' and still holds some taxis, a bus and truck fleet and garages all over the country.

Three sources of evidence were collected during the field visits between December 1993 and February 1995 for the following chapter. First, a review of the relevant laws and other relevant documents collected in the ministries and privatisation committee, such as the draft programmes and guidelines for valuation, was carried out. All the documents were reviewed in the original Azeri language as, for most documents, there are no translations available or, where there are, they are not accurate and might lead to misinterpretations.² Second, extensive personal interviews were conducted with personnel of the privatisation agency, the council of ministries, ministries and other institutions, presidential advisers, enterprise managers, workers' councils and trade union representatives, academics and journalists. The third source was the observational protocols made during the field study. Again, most of the information of the following chapter is based, if not otherwise stated, on the author's fieldwork protocols and transcripts of interviews with the management and employees of plants, and various institutions.

Section one presents a brief history of the early moves toward privatisation in the Soviet period and the first months of independence of Azerbaijan. The two following sections scrutinise in detail the key provisions of the framework law for privatisation and the organisational prerequisites given by the privatisation agency. Section four assesses the methodology on which valuation of assets is based in Azerbaijan. Section five examines the 1993-1994 draft privatisation programme focusing on the proposed methods of privatisation.

¹ Many taxi drivers reported that they had to pay bribes on top.

² The policy of the EBRD, IBRD and IMF is therefore to send out Turkish speaking representatives and consultants to Azerbaijan.

5.1 The privatisation debate and developments before 1992

The early Perestroika era laid the foundations of far-reaching changes in property rights resulting in insider control and spontaneous privatisation.³ Milestones in this period have been (1) the Law on State Enterprises, passed mid-1987, which intended to introduce a considerable degree of decentralisation, greater autonomy to state enterprise managers and more influence over enterprise affairs to worker collectives;⁴ (2) a series of laws regulating co-operatives, which legalised the unofficial economy of semi-legal private and co-operative enterprises; (3) and the decree 'on Leasing and Lease Relations', enacted in mid-1989, along with related acts and decrees, which spurred development of enterprises in which enterprise managers and workers could independently operate assets leased from the state.

It was only in autumn 1990 that formal privatisation was taken up in official economic reform proposals as a vital aspect of the transition to the market economy of the USSR (cf. Radygin 1995: 7-19).⁵ The economic reform programme 'Main Trends of Stabilisation of the National Economy and Transition Towards a Market Economy' adopted by the Supreme Soviet in October 1990 presented some general notions on privatisation which were strengthened by the following IV. Congress of People's Deputies of the USSR (cf. Radygin 1995: 16). The 'Programme of Joint Actions of the USSR Cabinet of Ministers and the Government of the Sovereign Republics to Extricate the Country's Economy from Crisis in Conditions of the Transition to the Market'⁶ signed in July 1991, envisaged the following measures concerning privatisation:

1. to agree in the second quarter of 1991 at union-republic agreement level on the principles and functions of privatisation (section II);
2. to prepare and implement from the third quarter of 1991 corresponding Union and republican programmes and regulations (sections II and VI);

³ For a review of reform proposals and policies during the Gorbachev era, see Desai (1992), Hewett (1988), and Gregory and Stuart (1994 and 1995). See also section 4.3 of this volume.

⁴ These legal concessions to worker collectives were never enforced in practice (see Frydman et al. 1993b: 19).

⁵ The '500 days' programme proposal of Shatalin included a comprehensive privatisation programme.

⁶ See SWB 13 July 1991.

3. to adopt a programme to dispose of loss-making enterprises, temporarily suspend managers of such enterprises, the change of management and turn-around, reorganisation and compulsory privatisation (section V);
4. priority in privatisation of (1) unfinished construction of production facilities (section V), (2) enterprises and organisations which provide services to the population, manufacture consumer goods, produce food or process agricultural raw materials and of small enterprises in industry, construction and transport (section VI);
5. priority given to the creation of joint-stock companies, partnerships, collective (people's) enterprises and enterprises leased with the right to buy (section VI);
6. preferential terms for the transfer of shares and equities to members of work collectives (section VI).

In June 1991 the Yavlinsky-Allison programme was put forward which outlined two stages of privatisation (1991-1993 and 1994-1997) gradually to include large enterprises (cf. Radygin 1995: 18).⁷ All programmes were over-optimistic both in terms of their given timetable and the feasibility of their approach and ignored the political and economic realities. First, they lacked a clear demarcation of rights and responsibilities between the centre and the individual republics, which was vital at the time of disintegration. Second, they did not adequately address issues of monopoly enterprises and increasing industrial concentration as a result of organisational changes.⁸ Third, the proliferating problem of insider control was completely neglected.

None of these programmes was implemented in practice. They were overtaken by the collapse of the USSR and the subsequent independence of the republics. Debates and plans about privatisation held at the centre had little impact on Azerbaijan. On 30 August 1991 Azerbaijan declared its independence and the formal privatisation process stalled through debates in parliament. There has been no strong lobby for formal privatisation. Insiders who potentially have an interest

⁷ The Yavlinsky-Allison plan was used by Gorbachev as basis for discussions with the G-7 at the July 1991 Summit.

⁸ See section 4.3 of this volume.

in formal privatisation felt safer under the existing framework. The strong industrial bureaucracy opposed privatisation. Due to the political instability none of the stakeholders had an interest in the formal privatisation process commencing. Rather emphasis seems to have been put on asset stripping. A major incentive behind the reluctant drive for formal privatisation no doubt has been international assistance, which rated progress in privatisation as a major indicator for development and hence creditworthiness. The framework law for privatisation, although expected to be passed in April 1992, was only adopted in January 1993. Table 5-1 summarises the important events in the formal privatisation process in chronological order.

Table 5-1: Chronology of selected important events in the formal privatisation process in Azerbaijan

<i>Date</i>	<i>Events</i>
October 90	The economic reform programme 'Main Trends of Stabilisation of the National Economy and Transition Towards a Market Economy' adopted by the Supreme Soviet.
December 1990	IV. Congress of People's Deputies of the USSR
June 1991	Yavlinsky-Allison programme
July 1991	'Programme of Joint Actions of the USSR Cabinet of Ministers and the Government of the Sovereign Republics to Extricate the Country's Economy from Crisis in Conditions of the Transition to the Market'
June 1992	ASPC is established as body responsible for privatisation.
7 January 93	The law 'On Privatisation of State Property in the Republic of Azerbaijan' is adopted.
March 93	First draft privatisation programme is submitted to parliament by president Elchibey; however, never approved.
28 April 94	Revised draft privatisation programme is submitted to parliament by President Aliiev.
February 95	Appointment of Azizov Tofik Museyib oglu as new chairman of ASPC with rank of Deputy Prime Minister

5.2 The legal framework of privatisation

The framework law for privatisation in Azerbaijan is the law 'On Privatisation of State Property in the Republic of Azerbaijan'. Following a prolonged period of debate on several earlier versions, it was adopted by Parliament and approved by President Elchibey on 7 January 1993. In Table 5-2 the key provisions of the law,

which are discussed below, are listed with the relevant articles.⁹ The discussion of the law is more detailed as it is based on the original Azeri version, which is not available in an accurately translated English version.

Table 5-2: Key provisions of the main privatisation law

No.	Subject matter	Article
1.	Definition of privatisation	§2
2.	Objects of privatisation	§§4, 11, 12
3.	Body responsible for privatisation	§§3, 9
4.	Privatisation programme	§10
5.	Valuation	§16
6.	Eligible buyers	§§5, 26
7.	Foreign participation	§8
8.	Methods of privatisation <ul style="list-style-type: none"> • Vouchers • Investment funds • Tenders • Employee buy-out • Sale of shares • Public auctions • Sale of leased property 	§18 §19 §§7, 14, 23 §§14, 17 §§7, 14 §§7, 14, 22 §14
9.	Corporatisation	§14, 15, 24
10.	Procedures for privatisation	§§7, 14, 21, 22, 23, 25
11.	State guarantees <ul style="list-style-type: none"> • Employees • Participants 	§§7, 26 §25

Source: Law 'On Privatisation of State Property in the Republic of Azerbaijan'

(1) Definition of privatisation

Privatisation is defined as the 'transfer of state property into private property in line with the present law' (Art. 1).

'Property' is defined by §4 of the law 'On Property', passed on 9 November 1991 still under President Mutalibov. It includes:

[...] land, internal and territorial waters, continental shelf, airspace, flora and fauna, enterprises, equipment, buildings, structures, raw materials and other materials, money, securities, other properties of industrial, social, cultural and other character, products of intellectual and creative activity.

There are three major shortcomings of this definition. First, the law does not make any provision for divestment of user rights. As discussed in section 4.3, leasing

⁹ Unless otherwise stated, article numbers in this section refer to those of the framework law for privatisation. The quotations were translated from the author into English.

has already been practised in Azerbaijan since the end of the 1980s. A new law regulating leasing was only passed on 29 November 1994. Second, the law does not distinguish between small and large privatisation, and between privatisation of means of production and other assets. Privatisation is approached with a wholesale attitude. Third, the concept of privatisation is not embedded in a framework of enterprise restructuring and change of corporate governance.

(2) *Objects of privatisation*

The targeted objects are outlined in §4 as

all enterprises and other assets which are state property excluding enterprises and assets the privatisation of which is prohibited.

The latter are not defined by the law. The issue of which enterprises to exclude, especially in the oil industry, was fiercely debated in both parliament and public. According to some respondents the exclusions will often be subject to change. The draft privatisation programme of 1993-1994 lists enterprises which are not to be privatised.

The law distinguishes between three categories of enterprises and objects (i.e. commercial units like shops etc.) to be privatised:

1. by decision of 'supreme body of state and executive power', i.e. the president;
2. by decision of the body responsible for privatisation; and
3. by agreement with local authorities. Here, again, no specifications are made whether it has to be in accordance with rules and regulations given by the body responsible for privatisation or whether it can be carried out independently.

It is not specified which enterprises fall under the responsibility of the 'supreme body of state and executive power', the body responsible for privatisation and/or the local authorities. Thus, problems of competing interests could arise. Moreover, the transparency of the privatisation process is threatened as rules and regulations used by the body responsible for privatisation might not be followed by other bodies.

Unresolved is the issue whether to exclude social facilities of enterprises such as recreation, education, health and crèche facilities. Ideally the latter should be separated from production facilities and transferred to special trusts or local authorities. The inclusion of these facilities into an enterprise would be an unreasoned give-away.

(3) *Body responsible for privatisation*

§3 and §9 designate the body controlling state property responsible for the implementation of privatisation and directly subordinate to the president. §9 lists the duties of the body responsible for privatisation:

1. preparation of the annual privatisation programme;
2. systematic control over privatisation over all the territory of Azerbaijan;
3. establishing a regional network, responsible for the regional implementation, and controlling this network;
4. assessing privatisation, which has taken place before the law became active and initiating the legal prosecution through court and arbitration tribunal where applicable;
5. other functions specified by the main law and secondary laws;
6. valuation of enterprises and other assets;
7. determining (1) methods chosen, and (2) implementation procedures suiting different branches and individual enterprises and assets;
8. determining the distribution and use of privatisation proceeds.

All methodologies and other documents determining the *modus operandi* of the body controlling state property are prepared by the body itself and have to be approved by the president. The room for discretion of the body is designed quite generously by the law. Moreover, the parliament has no influence on the operation of the body controlling state property.

(4) *Privatisation programme*

The law requires the preparation of an annual privatisation programme. It has to include:

1. valuation of the enterprises and other assets concerned;
2. timetable of privatisation;
3. methods and terms used with individual enterprises and assets, and terms of share issue, in case of joint stock companies;
4. volume of vouchers, terms of distribution, and terms of payment;
5. use of revenue of privatisation.

The programme has to be submitted annually to parliament by the president no later than 1 November. Parliament has to approve the programme no later than 20 December (§10(2)).

As mentioned above, on 28 April 1994 President Aliev approved the 1994 privatisation programme and submitted it to parliament. It had not been approved by January 1995, the end of the field study period.

(5) Valuation

The law provides that state property will be valued according to the rules determined by the body responsible for the privatisation (§16(1)). The ASPC has prepared a methodology for valuation which is discussed below (cf. ARDÄK 1993b).

(6) Eligible buyers

According to §5, eligible buyers are:

1. the workers' collective of the enterprise. No specifications are given who is included in the workers' collective. §21 includes pensioners who worked at the enterprise for more than seven years and employees who are on agreed leave.
2. Citizens of Azerbaijan.
3. Legal entities, in which state ownership does not exceed 25%.
4. Foreign physical and legal persons.

(7) *Foreign participation*

The law imposes no restrictions on foreign participation (§8). It grants foreign partners of a joint venture an advantage, which is however not specified.

(8) *Methods of privatisation*

Methods approved include free transfer as well as sales:

- (1) tenders (§§7, 14, 23),
- (2) employee buy-outs (§§14, 17),
- (3) sale of shares through capital market operations and public offering (§§7, 14),
- (4) public auctions (§§7, 14, 22), and (5) sale of leased property to lessees (§14).
- (5) §16(2) mentions leasing as another possible privatisation method. However, it is not considered anywhere else in the law.

Payments can be made in privatisation-vouchers which are to be distributed to citizens and in local currency (§§7, 18). §19 envisages the establishment of investment funds as intermediaries to support the conversion of vouchers into enterprise shares. Private and public investment funds are to be operated under licence of the National Bank and hence are subordinated to the latter (§19(3)). §19(2) establishes that these new investment funds have to operate according to set rules and regulations. The latter have not been prepared yet, nor is it determined who is responsible for their preparation.

(9) *Corporatisation*

As preparatory steps for privatisation the law requires the establishment of open and closed (i.e. limited liability) joint-stock companies (§14(5)).¹⁰ These joint-stock companies can be with and without a controlling share of the state (§15). In which joint-stock companies the state is going to have a controlling share and who is to determine the latter, is not dealt with in the law. §24(2) states that the process

¹⁰ The shares of an open joint-stock company are publicly traded. The company is controlled by those who own the controlling packet of shares. Shares of a closed joint-stock company are not publicly traded. Owners are directly involved in the companies' control.

of corporatisation is governed by appropriate legislation. Such legislation had not been passed by January 1995. The law 'On Joint-Stock Companies' was only adopted on 12 July 1994 and has been in force since its signing in November 1994.

(10) Procedures for privatisation

Rules and regulations concerning the initiation of privatisation (§7(3)), tenders (§23), auctions (§22), sales of shares through capital market operations and public offering, and contracts (§25) are all to be prepared by the body responsible for privatisation and approved by the president. None of these rules and regulations had been prepared by January 1995. There are three shortcomings of the law concerning the procedures for privatisation. First, there are questions of responsibility for, and initiation of, the necessary restructuring prior to privatisation, i.e. (1) splitting up of enterprises by reducing vertical and horizontal integration, (2) spinning-off non-core activities, (3) partial closures, and (4) restating balance sheets including writing-off enterprise and inter-enterprise debt, are not addressed by the law. As discussed before, the latter is a prerequisite for ensuring efficiency.¹¹

Second, no provisions are made concerning the future use of social and cultural facilities and the real estate of enterprises to be privatised. According to §7(4) they either can be privatised together with the enterprises or separately and in case no buyers can be found, they are to be transferred to the body responsible for privatisation.

Third, the privatisation law does not consider the broad issue of environmental pollution caused by existing plants and the cleaning up of industrial wasteland. Inadequate rules and regulations concerning environmental protection during Soviet times have stored up problems for future generations even in supposedly environmentally safe industrial processes. There are few records on the extent of the pollution, either because records were not kept, or because they

¹¹ For a detailed theoretical discussion of restructuring in general and restructuring prior to privatisation, see section 2.2 and 3.4.

were secret. Currently the monitoring and assessment of environmental damage is limited due to lack of personnel and equipment. The State Committee of Ecology and Environmental Protection (1993) made in their report a first attempt to record the extent of environmental damage. The way of internalisation of these external effects has to be decided prior to privatisation, as property rights are significantly affected. Renegotiating at a later date would be politically infeasible and would moreover cause high transaction costs.

(11) State guarantees

The law gives the following guarantees to employees. First, employees who did not benefit in forms of shares are granted compensation by the new owner, in case of lay-offs due to restructuring or liquidation. According to §7(6) the height of the latter is determined by the regulations on tenders and auctions which have to be prepared by the body responsible for privatisation. No such regulations had been prepared by January 1995.

Second, §26(1) grants employees made redundant due to restructuring or liquidation the rights and privileges given by the legislation on redundancy due to restructuring and liquidation. Such legislation was not prepared by January 1995.

Third, employees of SOEs turned into joint-stock companies have the privilege to buy shares at face value or with a concession (§7(7)). The law does not determine the percentage of shares which can be bought under concession or at face value, nor does it determine the level of the concession.

Fourth, pensioners, who have worked in an enterprise for at least seven years and employees on negotiated leave enjoy the same rights on compensation and to buy shares at a reduced price.

Participants are granted a state certificate confirming their property rights for their bought or otherwise received assets by the body controlling the property to be privatised §25(1). This is not an adequate protection for buyers and therefore jeopardises the whole privatisation initiative. A law is required that gives the present body controlling state property the right to convey clear, legal and irrevocable title to the property bought or otherwise received. Often, however, the body responsible for a SOE cannot be clearly identified. There are various

competing stake holders such as the municipality and the former branch ministry (now mostly a holding company) to which the enterprise is subordinated. Present ownership structures have to be clarified. It would be easier if the ownership title could be transferred by one sole agency in order to avoid or limit time-consuming procedures and corruption. Ideally the agency which is responsible for the privatisation of the assets should also be able to transfer the ownership rights.

Table 5-3 summarises the subordinate legislation required which is mentioned by the privatisation law. Table 5-4 outlines further measures required which is not acknowledged by the law.

Table 5-3: Subordinate legislation required by the main privatisation law

No.	Subject matter	Responsible authorities	Progress made before February 1995
1.	Annual privatisation programme	Body responsible for privatisation	The ASPC has prepared the annual programme for 1993-1994, however it was not approved by parliament.
2.	Classification enterprises which are exempt from privatisation	Not named	The draft privatisation programme of 1993-1994 includes a list of such enterprises.
3.	Corporatisation	Not named	Legislation which regulates this process had not been passed by January 1995. The law 'On Joint-Stock Companies' has been in force since November 1994.
4.	Classification of enterprises in which the state is going to have a controlling share.	Not named	None
5.	Clarification of which enterprises fall under the responsibility of 'supreme body of state and executive power', the body responsible for privatisation, and/or the local authorities	Not named	The draft privatisation programme for 1993-1994 contains such a classification of enterprises. However, it can be argued that it should be dealt with in a separate legislation.
6.	Law that gives the present body controlling state property the right to convey clear, legal and irrevocable title to the property bought or otherwise received.	Not named	None
7.	Clarification of the present bodies controlling particular assets, i.e. ownership structures.	Not named	None
8.	Valuation	Body responsible for privatisation	The ASPC has prepared a methodology for valuation.
9.	Details on advantages the law grants for foreign partners of a joint venture	Not named	None
10.	Investment funds	Not named	None
11.	Initiation of privatisation	Body responsible for privatisation	None
12.	Tenders	Body responsible for privatisation	None
13.	Auctions (including voucher-auctions)	Body responsible for privatisation	None
14.	Sales of shares through capital markets and public offering	Body responsible for privatisation	None
15.	Rules and regulations for sale of leased assets to lessees.	Not named	None
16.	Standard and complex contracts	Body responsible for privatisation	None
17.	Compensation of employees made redundant in the course of privatisation	Body responsible for privatisation	None
18.	Legislation on redundancies	Not named	None
19.	Preferential sales to employees	Body responsible for privatisation	None
20.	Privatisation vouchers	Body responsible for privatisation	None
21.	Implementation procedures suiting different branches and individual enterprises and assets	Body responsible for privatisation	None
22.	Determining distribution and use of the revenue from privatisation	Body responsible for privatisation	The draft privatisation programme for 1993-1994 includes a short classification of possible revenue sources from privatisation. The revenue is supposed to be transferred in the state budget and used for the purpose of 'social and economic development of the republic' (ARDAK, 1994: 27)
23.	Organisation of regional networks	Body responsible for privatisation	None

Table 5-4: Further measures required for privatisation

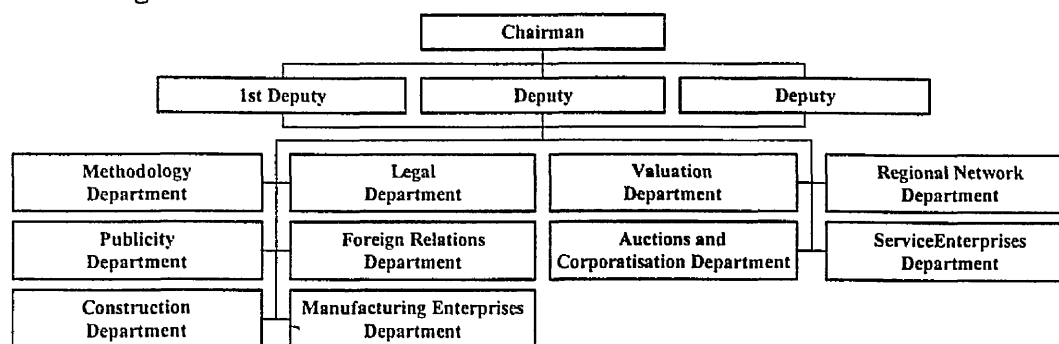
No.	Subject matter	Measures to be taken	Measures taken by February 1995
1.	Restructuring	<ul style="list-style-type: none"> Industrial policy Legislation on restructuring Programme Determining bodies which will be responsible 	In 1992 the Council of Ministries prepared a rudimentary draft programme for the restructuring of industry. It was never considered.
2.	Corporate governance	<ul style="list-style-type: none"> Company laws Training facilities Advisory centres 	<ul style="list-style-type: none"> The law 'On the Enterprise' determines the organisational and juridical forms of enterprises. It was adopted in July 1994. However, it contains inadequate provisions for corporate governance. The law 'On the Joint-Stock Company' was adopted on 12 July 1994 and is in force since November 1994. It makes some provisions for corporate governance. However, it will take a long time and training until even these rudimentary regulations will be in place.
3.	Liquidation	<ul style="list-style-type: none"> Legislation Determining responsible body 	The law 'On Insolvency and Bankruptcy' was adopted on 22 July 1994, however the decree of parliament, bringing the law into force had not been passed yet.
4.	Leasing as a method of privatisation	<ul style="list-style-type: none"> Rules and regulations for leasing procedures Determining bodies which will be responsible for these arrangements 	Law 'On Leasing in the Republic of Azerbaijan' was adopted on 29 November 1994.
5.	New accountancy standards suitable to a market economy	<ul style="list-style-type: none"> Rules and regulations for accountancy Determining bodies which will be responsible for the realisation and maintenance. 	None
6.	Environmental protection and clean up	<ul style="list-style-type: none"> Environmental policy Environmental protection and clean up legislation (e.g. emission standards etc.) Programme for the cleaning up of contaminated sites Determining bodies which will be responsible for the implementation of environmental policy (e.g. environmental monitoring etc.) 	<ul style="list-style-type: none"> There is a State Committee of Ecology and Environmental Protection. The law 'On Protection of the Environment' was passed in 1992 without any effect, does not address most issues.
7.	Social safety net	<ul style="list-style-type: none"> Programme to adapt present schemes to the new requirements Legislation 	A new Employment Fund was set up in October 1991 and is administered by the Ministry of Labour and Social Protection.

			However, its funds are hardly sufficient. ¹²
8.	Capital markets	<ul style="list-style-type: none"> • Legislation • Regulator 	The law 'On securities and stock exchange' has been passed November 1992. However, none of the required secondary legislation has been prepared yet.

5.3 The State Privatisation Committee

The ASPC was established as the body responsible for privatisation by presidential decree on 23 June 1992. Kudret Abdul Salim-Zade, according to many interviewees rather an outsider to the political establishment, was appointed as chairman.¹³ Its organisational form and modus operandi is determined by the Presidential Decree No. 137 dated 13 August 1992. It came into force on the same day as the main privatisation law (7 January 1993). The tasks featured by the August decree are in line with those featured for the body responsible for privatisation in the main privatisation law, discussed above. As can be seen in Figure 5-1 the ASPC comprises ten departments with 68 employees in total (August 1994).

Figure 5-1: Structure of the Azeri State Privatisation Committee



Source: ASPC

The status of the committee can be made out by observational evidence collected in 1994. The committee was located on one floor of a run down office tower block with concrete chunks falling off the walls - far less prestigious than

¹² See also section 4.2.1.

¹³ The author recognised that Mr. Salim-Zade has a strong Sheki accent (Northern Province of Azerbaijan). There are traditionally hardly any people from Sheki in the political establishment.

any of the offices of the obsolete old administrative bodies. Compared to equivalent bodies in other PCPEs and taking into account the responsibilities determined by the privatisation law, the committee was hopelessly understaffed. Some departments consisted only of one little room and were generally poorly furnished. The few telephone lines had to be shared between employees. The committee was not computerised, whereas most other administrative bodies (e.g. AME, AMF, CMA, Tax Inspectorate, Chief Auditor) had at least some computers and compiled data on them. There are several indicators for the lack of authority and competence of the committee. First, the committee was set up under President Elchibey. Many interviewees suggested that it would be highly unlikely that privatisation would be carried out by an institution not set up by President Aliiev himself.

Second, all the information compiled for the draft privatisation programme was collected from the ASPC, the CMA, the AME, and the former branch ministries turned into concerns. The valuation of the enterprises was based on the questionnaire filled out by the enterprises. The staff of the ASPC had hardly been to any of the enterprises in person. An inventory of the enterprises was not planned by the staff. The employees of the ASPC considered that to be the task of the relevant departments of the CMA, the AME, and the relevant concern. As discussed in chapter three, the valuation of assets is also of interest for bodies responsible for industrial policy. For the latter, the assessment of the 'political value' of medium and large sized enterprises is of importance to counter post-privatisation rent-seeking activities by the new owners. Moreover, as the valuation of enterprises is a rather politically sensitive issue, it should be carried out with a maximum of transparency. Thus, the involvement of different bodies is welcome. However, all the institutions involved in the Azeri context, except for the ASPC, consist of nomenklatura members, who are close to the insiders of the enterprises. It can be expected that any decision or action carried out by these institutions is biased towards insiders. The ASPC as a new institution should lessen this bias. However, it is questionable, whether the ASPC can impose any decisions and steps independently of these powerful institutions.

Third, regional structures, whose establishment is politically very sensitive due to powerful interest groups on regional level, have hardly been formed. Due to political opposition at regional level, it will take time to organise these formations and procedures towards the latter should have long begun. Thus, the authority of the ASPC on regional level is very limited.

Fourth, staff of the ASPC on all levels were not trained in the activities they are expected to pursue by law. Experience of other PCPEs was not taken into account in a systematic way. Some of the staff interviewed had only followed the privatisation process of Russia through the Russian television channel and other Russian media. However, the relevance of the Russian experience for the Azeri context was not adequately analysed. Experience of other PCPEs was hardly known.

Fifth, the wages paid to the employees of the ASPC were as low as in the whole public sector. They ranged between US\$5 and 20 (August 1994). As Discussed in chapter four, this is hardly enough to cover the cost of living. Thus, there is a strong incentive given to top up one's income with corrupt activities. Special income incentives should be given to ASPC staff to abate corruption.

5.4 Valuation of assets

The methodology for the valuation of assets was prepared by the ASPC (cf. ARDÄK 1993b).¹⁴ All valuations are to be based on the net book value, i.e. the difference between the value of assets and liabilities derived from the balance sheets. The net book value is supposed to be index-linked, with the price index being calculated annually by the ASSC (ARDÄK 1993b: 3). The net book values can be adjusted through the data of an inventory, which according to information from the CMA will involve the estimation of replacement and reproduction value of fixed and current assets. The ASPC can conduct inventories if doubts over a valuation arise (ARDÄK 1993b: 3). However, there has been no decree passed which would make an inventory obligatory, nor do there seem to be plans to do so.

¹⁴ For a discussion of the main issues of valuation in the context of privatisation in PCPEs, see Section 3.2.

There have also been no guidelines to conduct these inventories. As mentioned above, it is very difficult to assess the replacement or even liquidation value without any points of reference which would be available in a developed market economy.¹⁵

The valuation methodology distinguishes between (1) assets in the material production sphere and (2) assets in the non-material production sphere. The sales price (S) of an enterprises is separately calculated in these two categories as analysed below.

(1) Valuation of assets in the material production sphere

The net book value is adjusted using the criteria listed in Table 5-5 and analysed in more detail below. The sales price is derived through:

$$S = R + R(P + C + X + T - E)$$

Table 5-5: Additional valuation criteria for assets in the material production sphere

1.	Return on total equity coefficient (P)
2.	Local content coefficient (C)
3.	Export market coefficient (X)
4.	Transport link coefficient (T)
5.	Environmental pollution coefficient (E)

1. Return on total equity coefficient (P)

The first additional valuation criteria is return on total equity:

$$P = \frac{Y}{\phi} * 0.2$$

P	Return on total equity coefficient
Y	Profit ¹⁶ of previous year
ϕ	Fixed assets

The influence on the sales price is rather small with an increase of maximally 20% of the net book value. Most enterprises, however, can be expected to have a

¹⁵ As mentioned in section 3.2, original prices were widely distorted.

¹⁶ The valuation methodology of the ASPC does not specify whether 'profit' refers to before or after tax profit.

negative return on equity. Considering the massive restructuring requirements, return on equity is a weak indicator for the future potential of enterprises.

2. *Local content coefficient (C)*

Local content increases the value considerably as can be seen in Table 5-6. Considering the de facto blockade of rail and other roads from Russia to Azerbaijan due to the on-going conflict in Chechenia, and the general problems of trade between the republics of the former FSU, the use of local content is an advantage for the short-term development potential of an enterprise.

Table 5-6: Local content coefficient (C)

	C	Local content (%)
1.	0.8	100
2.	0.6	> 75 and < 100
3.	0.4	> 50 and < 75

Source: (ARDÄK 1993b: 6)

3. *Export market coefficient (X)*

As can be seen in Table 5-7, all enterprises, regardless of whether they have domestic or export markets have a 60% mark-up of their net book value, which is rather arbitrary. Enterprises with export markets, as the methodology states, have an additional mark up of 20%. Existing export markets are an indicator for the potential of an enterprise. However, the market share has also to be considered. The production of most enterprises has decreased so dramatically that former export markets might have been lost in the meantime.

Table 5-7: Export market coefficient (X)

	X	Export market
	0.8	yes
	0.6	no

Source: (ARDÄK 1993b: 6)

4. *Transport link coefficient (T)*

Existing transport links raise the value of an enterprise and should be considered in a valuation. However, the specification of over- and underground transport link

refers more to passenger transport than goods transport, which is more essential to the enterprise (see Table 5-8). The distance to a port and transport to a port, road conditions etc. could also be considered. As such, the categories given are insufficiently specified. Moreover, depending on the size of an enterprise a rise of 80% of the net book value for a special railway link could be unreasonable.

Table 5-8: Transport link coefficient (T)

	T	Kind of transport link
1.	0.4	over-ground transport link
2.	0.4	underground transport link
3.	0.8	special railway link

Source: (ARDÄK 1993b: 6)

5. *Environmental pollution coefficient (E)*

The environmental pollution coefficient reduces the sales price as can be seen from the sales price formula and Table 5-9. However, the responsibility for potential environmental liabilities is unresolved. Neither are potential clean up requirements and new emission standards settled. Potential clean up costs could go into billions of US\$. The categories of large and small pollution are also far too general. The extent and kind of pollution has to be more clearly specified and considered accordingly.

Table 5-9: Environmental pollution coefficient (E)

	E	Extend of environmental pollution caused by production
1.	0.4	large
2.	0.2	small

Source: (ARDÄK 1993b: 6)

(2) *Valuation of assets in the non-material production sphere*

The sales price of assets in the non-material production sphere, i.e. service sector, is calculated as:¹⁷

¹⁷ As stated before, the focus of this work is the privatisation of large and medium sized enterprises. The assets in the non-material production sphere comprise mostly small enterprises of the service sector. However, to gain a total picture of the valuation methods and the general attitude taken the valuation of these assets is briefly discussed.

$$S = R + R(L + B + F + K + I + H)$$

As Table 5-10 and the details below show, the criteria for the non-material production sphere are more elaborate than for the material production sphere. However, one has to keep in mind that these so-called 'businesses' are often only commercially used premises or which have such potential.

Table 5-10: Additional valuation criteria for assets in the non-material production sphere

1.	Location coefficient (<i>L</i>)
2.	Activity coefficient (<i>B</i>)
3.	Customer frequency coefficient (<i>F</i>)
4.	Special features coefficient (<i>K</i>)
5.	Sanitary facilities coefficient (<i>I</i>)
6.	Ceiling height coefficient (<i>H</i>)

1. *Location coefficient (L)*

The location is of immense importance especially for the non-material production sphere. However, the categories listed in Table 5-11 are far too general. There are enormous differences between locations within Baku for example. Location should also be considered in the material-production sphere.

Table 5-11: Location coefficient (*L*)

	<i>L</i>	Location
1.	2	city
2.	1.5	regional centre
3.	1.2	village in non-mountainous area and regional centre in mountainous area
4.	0	village in mountainous area

Source: (ARDÄK 1993: 7)

2. *Branch coefficient (A)*

The branch in which a business operates, even if in most cases it will change, is also an important indicator of earning potential. The categories listed in Table 5-12 are again too general and were set up rather arbitrarily, judging from interviews with ASPC staff. Hotels are rated as more valuable, as they generate hard currency from foreign business travellers. However, this might be the case in Baku, but is

unlikely in Kuba or Barda. Ideally there would have to be separate valuation criteria for each line of business and commercially used premises.

Table 5-12: Branch coefficient (*B*)

	<i>B</i>	Branch
1.	2.5	hotel
2.	2	transport, trade and catering
3.	1.5	renovation, communication and research and development
4.	1	health, sports, culture and disabled services

Source: (ARDÄK 1993b: 7)

3. *Customer frequency coefficient (F)*

This is an additional 'location' criterion (see Table 5-13). A shop in a heavily frequented area should be of more value than of a little frequented area. However, the mark up of 70% of the net book value of all businesses in the non-material production sphere is unjustified.

Table 5-13: Customer frequency coefficient (*F*)

	<i>F</i>	Customer frequency
1.	1.5	heavy frequented (e.g. kolkhoz market, trade centres, railway and bus stations)
2.	0.7	little frequented

Source: (ARDÄK 1993b: 7)

4. *Special features coefficient (K)*

The 'special features' criterion is another indicator for the location of the business. The categories displayed in Table 5-14 are more important for some branches than for others. Thus, for some branches this criterion could be unjustified. Besides, for many businesses, a basement location could be more attractive than a first floor location, as they could be more readily accessible. A basement location means for many areas in Baku that the water and gas pressure might suffice to guarantee supplies for the whole day.

Table 5-14: Special features coefficient (*K*)

	<i>K</i>	Special features
1.	0.8	free standing building
2.	0.6	first floor location
3.	0.4	second floor location
4.	0.2	basement location
5.	0.1	cellar location

Source: (ARDÄK 1993b: 6)

5. Sanitary facilities coefficient (*I*)

It is not very clear why the price of premises without sanitary facilities is still marked up by 20% (see Table 5-15).

Table 5-15: Sanitary facilities coefficient (*I*)

	<i>I</i>	Sanitary facilities
1.	0.8	water supply, canalisation, water heater, district heating system
2.	0.6	water supply, sewage, district heating system
3.	0.4	water, canalisation
4.	0.2	no facilities

Source: (ARDÄK 1993b: 6)

6. Ceiling height coefficient (*H*)

This is again a criterion which has only significance for a few businesses. It is questionable whether it should be generally applied (see Table 5-16).

Table 5-16: Ceiling height coefficient (*H*)

	<i>H₀</i>	Height of ceiling
1.	0.6	more than 3 m
2.	0.4	between 2 m and 3 m
3.	0.2	less than 2 m

Source: (ARDÄK 1993b: 6)

As discussed above, valuation in the context of PCPEs should have three aims: (1) to assist the allocation of scarce investment resources, (2) to guide future industrial policy, and (3) to bolster against asset stripping.¹⁸ These are therefore the benchmarks against which the valuation method has to be measured. It might be desirable that the valuation is carried out as 'objectively' and transparently as possible. However, all the objective elements of valuation, e.g. historical financial

¹⁸ See section 3.2 for a more detailed discussion.

statements and points of reference given by the capital market, are only occasionally available and are widely distorted in PCPEs. Thus, the use of subjective elements, which no doubt are used in any valuation, are not only unavoidable, but also necessary in the transition period of PCPEs. The chosen valuation method and the way it is carried out do not fulfil any of the above aims. First, as discussed above, the net book value does not adequately reflect the potential of a business. In the case of Azerbaijan, like most other PCPEs, the book value is moreover widely distorted. These deficiencies are not alleviated by the additional criteria used, as these are too rough and ready. Most interviewees expected an under-valuation of assets.¹⁹ The value of most assets has to be newly estimated in the form of a broad inventory. This inventory is particularly necessary, as it is unknown how much of the fixed and current assets are still actually present and, if present, operational.

Second, in this 'inventory campaign' it should be decided which enterprises will have to be liquidated and which have future potential. Enterprises to be liquidated should be dealt with separately. The liquidation value of these can be assessed. Assets with 'political value' should also be dealt with separately.²⁰

Third, the future potential of most enterprises should be assessed on the basis of a business plan, evaluating potential product lines, markets, required capital expenditures and timing, organisational restructuring including the institution of inventory and administrative controls, etc. These business plans could also assist potential investors in their decisions.

There are a number of other unresolved issues with the approach taken. First, there are no special criteria for the valuation of the land the enterprises are built on and surrounded by. Land is mentioned as a fixed asset by the valuation methodology (cf. ARDÄK 1993b: 2). However, in the absence of land registration laws and institutions many ownership disputes could arise. The acquisition of real estate is a motive for many potential buyers. Thus it is an important issue whether the premises of enterprises are on prime location or remote, whether they are immediately available for construction purposes, etc.

¹⁹ However, most respondents expect also that bribes have to be paid on the side.

²⁰ See section 3.2 for the discussion of 'political value'.

Second, another unresolved issue is the dealing with, and valuation of, social facilities of enterprises such as club houses, recreation, education, health and crèche facilities. There have to be separate valuation criteria and guidelines for these.

Third, potential environmental liabilities are hardly considered. Clean up costs can be expected to be quite considerable for some industrial sites. Thus, a sound evaluation of the environmental damage has to be made. The question of responsibility for liabilities has to be solved.

Fourth, after the housing privatisation, medium and large enterprises were left with a kind of freeholder possession of former employees' quarters. The legal basis for these is still very uncertain. At the moment, the enterprises are liable for major structural repairs of those houses in which the flats are in the meantime private. These liabilities have also to be considered. In the long-run it can be expected that the new owners will try to avoid these responsibilities. Again, a legal clarification of duties and rights is required.

Fifth, the additional criteria used are mostly too unspecified and are only of significance for some lines of business. This makes the whole valuation rather arbitrary. It is inappropriate to value all enterprises under the same set of general criteria.

5.5 The 1994 draft privatisation programme

5.5.1 The scope of privatisation envisaged in the draft programme

The 1994 draft privatisation programme was prepared in accordance with the main privatisation law. As mentioned above, it was approved by the president on 28 April 1994. However, it failed to be adopted by parliament by January 1995, the end of the field study period. The privatisation programme deals exclusively

with the enterprises and commercial units (e.g. shops, restaurants, workshops).²¹ The programme covers 1994 and is intended to determine objectives, tasks and methods of this first stage as well as setting the basis for the following years.

The 1994 draft programme is a revised version of the 1993 programme which was rejected by parliament. The most frequently mentioned reasons for the rejection of the 1993 programme were the intensifying of the Karabagh conflict and the coup against Elchibey and subsequent change of the president. Within parliament the debate was centred in both years around problems of valuation and whether non-profitable enterprises should be privatised first. The discussions were fuelled with the fear of manipulation of asset values by insiders and eventually an under-priced sell-out of state assets. The differences between the 1993 and 1994 programmes are only cosmetic, and there are no changes in scope and methods (cf. ARDÄK 1993). Thus only the latter will be discussed here in more detail.

The 1994 draft programme proposes the eventual privatisation of 54.4% of all state enterprises and objects employing 38.1% of the total workforce (see Table 5-19). The programme aims to privatise 66.1% of enterprises in material production employing 64% of the workforce in the respective branches and 53% in non-material production employing 9.7% of the workforce (see Table 5-19). Privatisation is intended to be carried out in three stages (see Table 5-17). The first stage (1994-1995) targets small privatisation and is the main concern of the draft programme. Table 5-18 shows the classification of enterprise sizes in different branches. For 1994 only 4.1% of all enterprises employing 2.3% of the workforce were targeted, which can be understood as a compromise with forces against formal privatisation.

²¹ As mentioned above, the privatisation of the housing stock is guided by the Law 'On the Privatisation of Housing' passed in 1993. Land privatisation will be based on the law 'On the Principles of Agrarian Reform' and the law 'On Sovkhoz and Kolkhoz Reform' once they are passed and enforced.

Table 5-17: Stages of the privatisation process envisaged by the draft programme of 1994

Stage	Proposed period	Measure	Description
1.	1994-1995	Small privatisation	<ul style="list-style-type: none"> shops, workshops, small industrial enterprises, catering and service outlets non-profitable enterprises unfinished construction projects
2.	1996-1998	Privatisation of medium to large enterprises	
3.	after 1998	Large privatisation	

Source: ASPC

Table 5-18: Classification of enterprise sizes according to number of employees

<i>Branch</i>	<i>'Small'</i>	<i>'Medium'</i>	<i>'Large'</i>
Industry	50	51-300	>300
Transport	15	16-75	>75
Construction	25	26-150	>150
Trade	10	11-50	>50
Services	10	11-50	>50

Source: ASPC

Table 5-19: The proposed privatisation programme of 1994

	Total number of enterprises and objects			Number of enterprises and objects proposed to be privatised			Number of enterprises and objects proposed			Number of enterprises and objects proposed to be privatised in 1994		
	Number of enterprises	Fixed capital (Manat million)	Number of employees (000s)	Number of enterprises	Fixed capital (Manat million)	Number of employees (000s)	Number of enterprises	Fixed capital (Manat million)	Number of employees (000s)	Number of enterprises	Fixed capital (Manat Million)	Number of employees (000s)
I. Material production	6565	82700	842.9	44.3	66.6	52900	66	539	64	152	213.5	11.8
Industry	2409	34400	389.3	20.5	70	20600	60	234	60	37	96.7	3.4
Agro-industrial complex	916	25500	244.6	12.8	70	16500	65	170	70	44	70.0	2.1
Construction and construction materials	2740	8900	209	11	62	5800	65	135	65	71	46.8	6.2
Unfinished construction	500	13900	10.5	-	70	10000	76	-	-	153	3672	-
II. Non-material production	52582	49600	708.9	37.6	53.3	13600	31.6	185	9.7	2176	29.5	32.3
Trade & Public utilities	12781	1900	62.4	3.2	90	1600	84	42	67.3	1489	17.0	26.1
Personal services	11746	400	57.9	3.0	89.4	300	75	46	79.4	487	1.7	6.1
Transport	370	17900	175	9.2	-	-	-	-	-	199	10.8	0.1
Communication	222	1200	27	1.5	49.5	600	50	13	48.1	-	-	-
Education	6891	2200	192.5	10.3	20	500	22.7	36	18.7	-	-	-
Culture and Art	9396	4600	30.9	1.6	10.6	400	8.7	2	6.5	-	-	-
Housing and Community services	407	11200	24	1.3	58.9	6600	58.9	12	50	-	-	-
Health care and sports	10580	1800	112.4	6.0	28.4	600	33	30	26.7	-	-	-
Printing and publishing	43	100	4.9	0.3	-	-	-	-	-	-	-	-
Science & scientific services	146	1300	21.9	1.2	20.5	300	23	4	18.3	-	-	-
Other services	-	7000	246.2	18.2	-	-	-	-	-	-	-	-
TOTAL	59147	132300	1898	100	32155	66500	64.1	724	38.1	2327	243.0	44
												2.3

Source: ASPC

Table 5-20 presents the key provisions with their relevant articles of the 1994 draft privatisation programme evaluated below. The discussion of the programme is again more detailed as it is based on the original Azeri version, which is not available in English.

Table 5-20: Key provisions of the 1994 draft privatisation programme

No.	Subject matter	Article
1.	Categories of enterprises and assets <ul style="list-style-type: none"> 1. those which are exempt from privatisation; 2. those which are to be privatised by decision of either Parliament or President; 3. those which are to be privatised by decision of the ASPC; 4. those which are to be privatised with agreement of the local authorities; 5. those which are liable to obligatory privatisation. 	§1 §2.1 §2.2 §2.3 §2.4
2.	Registration of SOEs, inventory and valuation	§3
3.	Regional organisation and implementation of privatisation	§8
4.	Privatisation loans	§9
5.	Foreign participation	§6
6.	Information dissemination and Public relations	§11
7.	Social protection during the privatisation process	§10
8.	Distribution and use privatisation proceeds	§7
9.	Corporatisation	§4.4
10.	Privatisation in the different branches of the economy <ul style="list-style-type: none"> 1. Material production <ul style="list-style-type: none"> • Industry • Agro-industrial complex and food processing • Construction • Unfinished construction 2. Non-material production <ul style="list-style-type: none"> • Trade, public and personal services • Transport and Communication • Other services 	§12.1.1 §12.1.2 §12.1.3 §12.1.4 §12.1.5 §12.1.6 §12.1.7
11.	Methods of privatisation <ul style="list-style-type: none"> • Tenders • Employee buy-out • Sale of shares • Public auctions • Sale of leased property • Voucher Programme 	§4.3 §4.2 §4.4 §4.3 §4.1 §5
12.	Timetable and procedures for privatisation	§13

Source: ARDÄK (1994)

(1) Categories of enterprises and assets

One of the most heavily discussed issues in parliament was the list of enterprises which were to be exempt from privatisation or need to special permission. The draft privatisation programme distinguishes between five categories of enterprises and assets:

1. those which are exempt from privatisation (see Table 5-21);
2. those which are to be privatised by decision of either Parliament or President, comprising mainly enterprises involved in the processing or production of strategically goods (see Table 5-22);
3. those which are to be privatised by decision of the ASPC (see Table 5-23);
4. those which are to be privatised with agreement of the local authorities (see Table 5-24); and
5. those which are liable to obligatory privatisation (see Table 5-25).

Heavy debate evolved around the obligatory privatisation of non-profitable enterprises. It was feared that insiders might claim their enterprises to be unprofitable in order to acquire them more cheaply and easily. As before in the main privatisation law, there is no clear demarcation of responsibilities between the bodies evolved: are different levels going to initiate privatisation themselves and what role will the ASPC have in this process? Another major deficiency which appears throughout the programme is that the enterprises are not seen in the context of their holding companies. A programme which does not effectively address the issue of industrial concentration described in section 4.3, is bound to be blocked by the industrial bureaucracy.

Table 5-21: Enterprises and assets exempt from privatisation

1.	Natural resources, forestry, resources in the Caspian sea, air space, and territorial waters.
2.	Preserved natural areas.
3.	Historical and cultural heritage, museums, archives and libraries, including their premises and buildings, their property and goods.
4.	Gold and hard currency fund, jewellery fund, social protection fund, and other funds outside the state budget.
5.	National bank, saving-banks, currency, bonds and other state securities.
6.	Ministries of defence, national security and internal affairs, and their property and resources.
7.	Institutions and organisations, financed by the state budget and those occupied with the social welfare of the population: large health institutions, fundamental science institutions, education bodies, secondary schools, telecommunication utilities with significance for the state, special health sanatoriums, boarding-schools, orphanages, crèche facilities, nursery homes, hospitals and sanatoriums for the disabled, for psychiatric treatment, sexually transmitted diseases, and alcoholism, and epidemic isolation hospitals.
8.	Geological, cartographic, geodesic, and meteorological organisations and institutions dealing with the environment and environmental protection.
9.	Epidemiological centres, veterinary, forestry and plant protection services.
10.	Medical science and education institutions.
11.	Patent, standards and measuring organisations, and institutions, and car-testing services.
12.	Pipeline maintenance organisations and systems.
13.	Water-supply and irrigation systems and their maintenance.
14.	State broadcasting company and state information and telegraph agencies.
15.	Metro and public motorways and their maintenance.
16.	Enterprises producing state honour medals and decorations.
17.	Enterprises producing, processing and/or storing narcotic and poisonous substances.
18.	Maritime port facilities, marine training facilities, merchant fleet, hydrographical organisations, maritime rescue, cleaning, repair and technology facilities, and maritime supervisory body.
19.	Industrial and domestic waste-disposal units and depots, solid and liquid radioactive waste, contaminated meat and animal disposal units.
20.	Prisons and special detention units.
21.	Infrastructure and utilities of cities and districts (i.e. electricity, heating, gas, and water supply systems, sewerage system, and street lightening), and their maintenance.
22.	Assets and operations of the gas industry of republican and regional importance.
23.	Cemeteries.

Source: ARDÄK (1994: 4-6)

Table 5-22: Enterprises and assets privatised by decision of either Parliament or President

1.	Enterprises and assets with defence character, producing and processing strategic goods and resources, and subordinate scientific institutes, projects, and organisations.
2.	Civil defence institutions and assets, and mobilisation authorities.
3.	Refrigerated and other storage facilities for state and mobilisation reserves.
4.	State animal husbandry farms.
5.	Cotton-cleaning plants.
6.	Tea-processing and -packaging plants.
7.	Alcoholic beverages and tobacco production and processing plants.
8.	Extractive industry (except plants for local raw materials).
9.	Enterprises and assets processing rare and precious metals and stones.
10.	Enterprises and amalgamations of the fuel, energy and petrochemical industries (except for construction and industrial construction operators and supervisory body) and oil fields with significance for the republic.
11.	Commercial banks (except for private commercial banks).
12.	Railways, aviation, sea transport and telecommunication systems and networks (except for the press network).
13.	Social and cultural institutions (i.e. public health, education, sport, and cultural facilities), special hostels and crèche facilities which are not exempt from privatisation (except for those on the balance sheets of enterprises, amalgamations and organisations).
14.	Universities and secondary schools, research facilities, except for those exempt from privatisation.
15.	Organisations concerned with foreign economic and trade relations.
16.	Printing and publishing enterprises.
17.	Spa facilities and sanatoriums.

Source: ARDÄK (1994: 6-8)

Table 5-23: Enterprises and assets privatised by the decision of the ASPC

1.	Medium and large sized enterprises not exempt from privatisation or under the authority of either parliament or president.
2.	Assets and property not used any longer due to reduction in armed forces.
3.	Inland waterway transport businesses.
4.	International, inter-city and inter-regional goods transport, service stations and depots.
5.	Large enterprises of the agro-industrial complex.
6.	Food processing industry and enterprises supporting the agricultural sector.
7.	Selection and hybrid centres, stud-farms, horse race tracks, seed testing authorities, agricultural laboratories for testing crops, precious and rare fish farms, and special sovkhoses (only with the consent of the concerned authorities).
8.	Enterprises and assets producing medical equipment, materials and pharmaceuticals (except for those exempt from privatisation).
9.	Enterprises and assets producing food for children.
10.	Mobilisation resources (at the time of privatisation, mobilisation resources will be separated from other assets of enterprises).
11.	Petrol and oil selling operations (e.g. filling stations).
12.	Handicraft and art workshops.

Source: ARDÄK (1994: 8-9)

Table 5-24: Enterprises and assets privatised with agreement of the local authorities

1.	All goods transport facilities (except for those privatised from the ASPC), lorry and truck maintenance services.
2.	Inter-city and -region passenger transport (except for taxis).
3.	Small and medium sized agricultural enterprises.
4.	Baths and laundries.
5.	Party (wedding etc.) parlours.
6.	Waste processing plants.
7.	Chemists (provided they are regulated by the state).
8.	Local health, education, culture and sports facilities (except those exempt from privatisation).

Source: ARDÄK (1994: 9-10)

Table 5-25: Enterprises and assets liable to obligatory privatisation

1.	Enterprises of wholesale and retail trade, kiosks, catering and other service outlets.
2.	Trade, service, transport and construction enterprises and assets, set up with means of the state budget, or different state organisations and enterprises, and belong to 'Azeritifik' and its local organisations.
3.	Very small, small and medium sized enterprises of the material production sphere.
4.	Non-profitable enterprises (except for those exempt from privatisation or privatised on decision of either Parliament or President).
5.	Taxi and car hire facilities, their depots, and maintenance facilities
6.	Small car repair and maintenance facilities.
7.	Unfinished construction projects.

Source: ARDÄK (1994: 10-11)

(2) Registration of SOEs, inventory and valuation

The programme intends to register all enterprises with all performance indicators. It also requests inventories to be carried out in all enterprises. However, the programme involves a number of bodies in the inventory process without setting a framework in which responsibilities are clearly demarcated and which ensures effective co-ordination of efforts. The valuation is to be carried out by a special commission authorised by the ASPC on the basis of accounting data provided by the enterprises and the methodology discussed above. By January 1995 the process of inventories and valuation was far from completed by and had hardly even begun.

(3) Regional organisation and implementation of privatisation

Regional structures of the ASPC are made responsible for the preparation and implementation of privatisation. As discussed above, the setting up of regional

networks of the ASPC had proved to be far more difficult than anticipated by the policy planners.

(4) Privatisation loans

The programme relies upon the privatisation being credit financed. However, no special loans are made available. Thus privatisation vitally depends on the weak banking system in Azerbaijan.

(5) Foreign participation

Involvement of foreign investors is particularly requested by the programme for the following groups of enterprises:

- unfinished construction;
- enterprises whose production has declined due to input shortages and lack of investments;
- enterprises processing food and other agricultural products;
- enterprises producing construction materials.

In the above mentioned enterprises foreigners can purchase shares except for preferred shares of the labour collective. However, foreign investors are not granted preferential conditions.

Special licences are required for foreigners investing in enterprises which are primarily engaged in research and development tasks, converted enterprises previously belonging to the defence sector, and monopoly enterprises in petrol and energy-related sectors. By January 1995 no regulations and preparations were made for these special licences.

For the formation of joint ventures special permission has to be obtained. The programme does not mention any regulations concerning this permission. Regulations determining the procedures and criteria for permission have not yet been prepared. Uncertainty may arise for foreign investors as wide discretion is granted to the ASPC and other executive bodies not specified to restrict and condition the size of the share held by foreigners. Parliament has to give its permission for foreigners to acquire the controlling stock of shares of an

enterprise, with no references made to the size of the enterprise. Very small enterprises would be also effected by this regulation which is bound to create unnecessary bureaucratic obstacles to foreign investment.

(6) Information dissemination and Public relations

The draft programme intends to facilitate widespread information and publicity work for privatisation. However, the minimum notification period of one month prior to an auction or requests for tender is far too short to initiate the desired degree of competition.

(7) Social protection during the privatisation process

The draft programme presumes that privatisation and expected restructuring is going to reduce at least temporarily the living standard of the population as a whole and particularly those living in areas around privatised enterprises. Thus, the latter are supposed to be advantaged in the privatisation process. However, the programme does not specify in which way this will be. Moreover, the programme refers to a comprehensive social protection programme which is supposed to be implemented to alleviate hardship caused by privatisation and expected subsequent restructuring. In January 1995 the latter had still not been set up.

(8) Distribution and use of privatisation proceeds

Various sources of privatisation proceeds are listed by the draft programme, e.g. entrance tickets for auctions. However, neither mechanisms of collection nor of distribution are adequately considered.

(9) Corporatisation

The draft privatisation programme understands corporatisation as a form of privatisation rather than as organisational reform. Medium and large sized enterprises can be transformed into partnerships or open and closed joint-stock companies on the suggestion of the privatisation commission and with approval of

the corresponding organs.²² The labour collective has to agree to this transformation with a three-quarter majority. In certain cases which are not specified, small enterprises can be transformed into partnerships or joint-stock companies. However this requires an approval of the entire labour collective. The process of corporatisation is carried out concurrently with the sale of shares to the labour collective and on the stock market, as described below. The ASPC is going to act as promoter of the companies. The share volume and the amount of shares obtained by the labour collective is to be determined either by the promoter or the labour collective. There are no regulations proposed in case of disagreement between these two bodies.

The processes of corporatisation and reorganisation should be carried out independently from and prior to privatisation.²³ Corporatisation and reorganisation of enterprises in Azerbaijan cannot be done without resolving present corporate governance issues, i.e. unbundling the quasi-holding structures. The draft programme hardly deals with this vital issue and totally underestimates time and resources needed for such a politically brisant task.²⁴ In the timetable a few months are reserved for this undertaking (see Table 5-29). In order to prevent the existing quasi-holding companies from privatising their entire structures via corporatisation, the latter is prohibited by the draft programme.

(10) Privatisation in the different branches of the economy

Table 5-26 discusses the proposed privatisation in different branches in more detail. To summarise: the proposed privatisation in industry prioritises small and medium sized enterprises in the light and wood industry both of which are

²² It is assumed, that the privatisation commission refers to the commission set up by the ASPC for the valuation of enterprises and that approval is only necessary for the enterprises listed in Table 5-22, Table 5-23, Table 5-24, and Table 5-25. These questions could not be resolved in interviews with ASPC employees.

²³ See section 2.1.22 for a more detailed discussion of the relevance of corporatisation in PCPEs.

²⁴ Another explanation is that the issue of unbundling of the quasi-holding structures is too politically brisant for the ASPC.

insignificant in Azerbaijan.²⁵ This indicates a compromise with the powerful industrial bureaucracy: only the production union Azärmeshä, the Khalg üçün mallar' state concern and Azärmebelsänaye state concern are immediately affected by the programme. Moreover, the majority of enterprises scheduled for privatisation are in the provinces, where the control of these quasi-holding structures is reduced or even has ceased completely. However, the industrial bureaucracy might oppose the privatisation of unfinished enterprise sites and objects, as their informal property rights over these assets would be affected depending on the form of privatisation.

Enterprises scheduled for privatisation in the agro-industrial sector are also mainly in the provinces. In some cases formal and informal income of local authorities could be effected by privatisation.²⁶ It will also depend on the role assigned to local authorities in the privatisation. It is questionable whether the local authorities will accept newly established regional structures of the ASPC to operate in what they claim as their domain.

The enterprises scheduled for privatisation in construction and production of construction materials are more attractive for their real estate than for their businesses. Ministries and local authorities, that these refurbishment departments are subordinated to, might oppose relinquishing control and possible informal income sources.

In the trade and services sector, formal and informal property rights of the local authorities are affected by the scheduled privatisation. Local authorities

²⁵ Here the Azeri classifications are used. 'Industry' comprises all industrial enterprises except for production of animal products, manufacture of food products and beverages, and manufacture of construction materials.

²⁶ The agro-industrial complex comprises the production of animal products and manufacture of food products and beverages.

might lose significant formal and informal income sources in this process. Similarly the privatisation of the automobile service workshops of the production union 'Avotmoservic' has repercussions on formal and informal income streams of the latter.

Table 5-26: Proposed privatisation in the different branches of the economy

	Priorities	Total number of priority enterprises	Enterprises to be privatised in 1994	Comments
Industry	Priority is given to small and medium sized enterprises in the light and manufacture of wood and wood products (including paper and furniture).	<ul style="list-style-type: none"> 45 small and medium sized enterprises of the light industry; 11 enterprises of the enterprises manufacturing of wood and wood products. 	<ul style="list-style-type: none"> 12 medium sized enterprises of the light industry, the biggest of which has 142 employees; 4 medium sized enterprises manufacturing wood and wood products. 	Only four of the enterprises to be privatised in 1994 are in Baku: (1) Baku Cotton Factory, (2) small leather products factory in Baku, (3) Baku Experimental Furniture Factory, and (4) 'Nur' Baku Stationary Factory. The other twelve enterprises are all in the provinces. All enterprises had ceased production due to shortage of raw materials, which in case of the wood and wood products industry were all imported from other republics of the FSU. As described in section 4.2.3, manufacturing of wood and paper products is an insignificant industry in Azerbaijan (3% of total employment). This is also the case for medium sized enterprises of the light industry.
Agro-industrial complex	Priority is given to small and medium sized enterprises processing food and producing silk-worm cocoons.	91 small and medium sized enterprises.	<ul style="list-style-type: none"> 17 enterprises processing food and beverages, the biggest of which is a fruit canning factory in the Kuba district with 433 employees; one small enterprise producing mineral water; three enterprises in the fishing industry; six poultry enterprises; six enterprises manufacturing grain mill products; 13 enterprises producing silk-worm cocoons. 	All enterprises except for four bakeries are in the provinces. Many enterprises either ceased production or drastically decreased production due to lack of spare parts and replacement equipment.
Construction and construction materials	Priority is given to small and medium sized enterprises manufacturing construction materials and operating in construction.	398 small and medium sized enterprises.	92 enterprises, the largest of which has 180 employees.	The majority are enterprises in construction, many of which are local authority and ministerial refurbishment departments (and construction brigades). The real estate of these enterprises (e.g. offices, workshops) are their most valuable assets.
Unfinished construction		Over 500 such enterprises and objects.	153 (35%) of these enterprises and objects: 87 have been commissioned by state companies, concerns and production unions, 13 by the Ministry for Agriculture, 22 by Baku city council and the rest by other ministries and committees.	The majority of these unfinished enterprises and objects were commissioned by state companies, concerns and production units and they are presently under their control. Thus it can be expected that there will be considerable resistance to their privatisation.
Trade, public and personal services		<ul style="list-style-type: none"> 3635 shops 1284 small and medium sized public service enterprises 1524 small and medium sized personal service enterprises (e.g. beauty parlours, hairdressers, etc.) 	<ul style="list-style-type: none"> 308 shops; 79 small and medium sized public service enterprises; 487 small and medium sized personal service enterprises. 	These shops and service outlets are currently under the control of the local authority. Changes in property rights will effect current formal and informal income streams of these authorities.
Transport, automobile services and communication		188 automobile service workshops of the production union 'Avtomotoserbis'.	126 automobile service workshops of the production union 'Avtomotoserbis'.	The privatisation in the transport sector aims at the small enterprises of the production union 'Avtomotoserbis', which would lose significant formal and informal income sources.

Source: ARDÄK (1994: 35-64).

Table 5-27: Evaluation of privatisation methods proposed by the 1994 draft programme

Privatisation method as termed in programme	Description	Distribution criteria	Administrative costs	Realignment costs	Contract type	Economic competence	Potential capital contributions	Insider control	Agency costs
Labour collective buy-out	The guidelines for buy-outs have still to be set up.	<ul style="list-style-type: none"> location of enterprise business line technical and economic indicators number of employees expertise of the labour collective 	low	low	complex	very high	low	restricted insider control	low
Public auction	The guidelines for auctions have still to be set up.	Price	low	low	standard	high	high	unknown	depending on firm size
Tender	The guidelines for tenders have still to be set up. Two variants of competitive tendering 1. Commercial competitive tendering 2. Non-commercial competitive tendering	<p>multiple criteria:</p> <ol style="list-style-type: none"> Price. ecological safety, economic competence and preparation of the buyer. Business profile and maintenance of functions of the enterprise, maintenance of employment level, and other criteria (not specified by the programme). <ol style="list-style-type: none"> Investment project, other criteria (not specified by the programme). 	high	high	complex	high	high	dependent of distribution criteria	low
Corporatisation	Corporatisation and subsequent sale to the labour collective in form of an ESOP. Three variants: 1. 49% of shares sold to labour collective at face value and on share market 51% of shares remain in State ownership 2. A maximum of 51% of shares sold to labour collective at face value; 49% sold on stock market; remaining shares are transferred to State Development Fund. 3. 51% of shares sold to labour collective at face value; remaining shares either sold to double face value to labour collective or on the share market.	<ul style="list-style-type: none"> employed by enterprise price employed by enterprise price employed by enterprise price 	low	low	standard	very high	low	insider control	high
Sale of lease enterprises	Easy sale terms, however not closer defined.	Leaseholder of enterprise	low	low	standard	very high	medium	restricted insider control	depending on firm size
Voucher programme	For sale of shares in operating companies. For sale of shares in state investment funds. (There are no such funds currently operating). For sale of shares in private investment funds. (There are no regulations and regulatory bodies for such funds).	- - -	high very high very high	low low low	standard standard standard	low low low	nil nil nil	unrestricted insider control unrestricted insider control unrestricted insider control	high high high

5.5.2 Methods of privatisation suggested in the draft programme

There are six methods of privatisation suggested by the draft programme, which are discussed below in more detail. Table 5-27 summarises the evaluation of the methods within the framework given in chapter 3.

(1) *Public auctions and tenders*

The draft programme states that auctions are carried out according to the guidelines 'on the sale of state assets through public auctions' and tenders with their respective guidelines, both of which have not yet been prepared. Mainly small and medium sized enterprises are intended to be sold through auctions or tenders. Assets of liquidated or bankrupt enterprises and of those whose performance has not been satisfactory over the past two years and unfinished construction sites are also to be sold either through public auctions or tenders. In case the labour collective is participating in an auction or tender it should constitute at least one third of the employees. The latter have to pay only one quarter of the sales price in the auction and can pay the rest in instalments over the period of one to three years.

In case of public auctions, the distribution criterion is the highest price. There is no reference made how the floor reservation price is calculated. This has to be included in the guidelines.

As discussed in 3.4.4 depending on the size of the enterprise auctions have high transaction costs.

There are two forms of tenders proposed: (1) commercial competitive tenders and (2) non-commercial competitive tenders. In the first variant, besides the price, other criteria are considered: (1) ecological safety, (2) economic competence and preparation of the buyer, (3) business profile and maintenance of functions of the enterprise, (4) maintenance of employment level, and (5) other criteria (not specified by the programme).

The second variant is used for enterprises and unfinished construction sites which require investments. Distribution criteria are: (1) investment project, (2) other criteria (not specified by the programme). The paid price is irrelevant as criterion.

As discussed in section 3.4.1 the transaction costs of competitive tendering are relatively high due to the essential requirement for competent and honest administrators and a well functioning legal framework with speedy means of contract enforcement. However, if contractual obligations can be enforced, this method could ensure the initial stages of restructuring, especially in case of unfinished construction sites and bankrupt enterprises.

(2) *Labour collective buy-outs*

According to the draft programme, labour collectives which are interested in the purchase of their enterprises will be advantaged regardless of the method of privatisation. Two-thirds of the collective has to agree to the buy-out. The buy-out can take place in a non-divisible and individualised-share transfer of the ownership rights to the labour collective.²⁷ The labour collective buy-out is regulated by the respective guidelines. The latter have not been prepared yet. In case of other potential buyers the ASPC determines the method of privatisation. The privileges of the labour collective are determined by the ASPC, taking account of the location, business line, technical and economic indicators, number of employees, and the expertise of the labour collective. However, there are no rules and regulations for the latter and there is a danger that they will be dealt with arbitrarily. The only privilege stated in the draft programme is that the labour collective has to pay only 50% of the purchase price immediately (which is regarded as a non-refundable pledge) and the rest in inflation-adjusted instalments. After privatisation the labour collective can freely choose an organisational form and the line of business of its enterprise.

²⁷ See also section 3.3.2 for a discussion of non-divisible and individualised-share transfer.

Members of the labour collective who did not acquire any ownership rights have to be paid out twelve times the minimum wage as compensation. These disadvantaged workers will also receive other advantages according to the draft programme. However, the latter are not defined.

Point 4.2.3 and point 12.6 of the draft privatisation programme suggest that the individual enterprise units or plants can be only privatised on their own and not together with their superstructure, i.e. state concerns, etc. It is not defined who is going to initiate and control the process of unbundling of the enterprise structures and there are no rules and regulations for this vital process.²⁸ The latter would imply a significant reduction if not abolition of the present quasi-holding structures. However this tendency is contradicted by point 12.5 which allows the transformation of the existing quasi-holding structures into holding companies in order to maintain the vertical integration of these enterprise complexes. There are no rules and regulations provided for the establishment of holding companies.

With this privatisation method a complex contract can be set up conditioning initial steps of restructuring, employment guarantees etc. Administrative costs will be higher, as negotiation, information and monitoring costs rise with a complex contract. However, costs will not be as high as with competitive tendering as there is a limited number of bidders (one for each enterprise). Labour collective buy-outs have relatively low transaction costs and offer significant advantages to other privatisation methods in terms of governance, restructuring and curbing of patronage networks.

(3) Privatisation through corporatisation and sale to labour collective and capital markets

Table 5-28 presents the three proposed forms in which shares can be sold. In all these sale forms, as a 'first stage',²⁹ individual members of the labour collective are not allowed to obtain more than 10% of shares at face value.

²⁸ As can be seen in Table 5-29 the draft programme assigns the enterprises, their superstructures and the enterprise registration authorities for implementation.

²⁹ It is not specified what the following steps will be.

In scheme two and three the labour collective would obtain the controlling block of shares and resembles an ESOP.³⁰ The individual worker would control his/her enterprise indirectly as shareholder in shareholder meetings. Whether the labour collective can curb short-sighted and opportunistic behaviour and dislodge possible incompetent and dishonest managers will depend on its strength and unity, and, on how far the new governance form of a joint-stock company can be established. The latter is again dependent on the overall institutional settings, particularly the soundness of the legal framework. The labour force in Azerbaijan is weak and fragmented, and there is no precedent in the governance form of a joint-stock company. There is the danger that relatively unrestricted insider control will be the outcome. However, as discussed in section 3.3.2, if this privatisation takes place at a plant level, insiders would be separated from the industrial bureaucracy and their patronage networks, i.e. the managers of state enterprises, state concerns, etc.

The first scheme would maintain the status quo. However, it depends on the reorganisation of the enterprises and the willingness and the strength of the executive whether the state can resume control over its enterprises. It is under the discretion of the ASPC over which enterprises the state is going to hold a controlling share.

All three schemes assume a functioning share market which is not existent in Azerbaijan. Shares obtained by the labour collective and those remaining as state property can only be sold after two years and then preferably to members of the labour collective. This blockage period would avoid initial fragmentation of ownership and support the commitment required in the restructuring period.³¹ In case of joint-stock companies of the closed type, the labour collective has to pay initially only 50% of their shares. The rest can be paid within a year. All three schemes have relatively low transaction costs and have also the advantage that a corporate governance system is set up with the privatisation.

³⁰ See section 3.3.2 for a detailed discussion of ESOPs.

³¹ See section 3.3.2 for the discussion of the advantages of transparency in ownership and control.

Table 5-28: Proposed share sale forms

	Share sold to the labour collective	Shares held by the state	Share sold on share market
1	A maximum of 49% of the shares is sold to the labour collective at face value.	51% and unsold shares are held by the state. Dividends are transferred to the employment fund.	Shares which could not be sold to the labour collective are sold on the share market at market prices.
2	A maximum of 51% of the shares is sold to the labour collective at face value.	Unsold shares are transferred to the State Development Fund.	49% of shares are sold on the share market at market prices.
3	51% of shares is sold to the labour collective at face value. Remaining shares are sold at double face value.	-	Shares not sold to the labour collective are sold on the share market.

Source: ARDÄK (1994: 20).

(4) The privatisation of lease enterprises

According to the draft programme, enterprises which are leased can be bought by their leaseholders. In case of the labour collective being the leaseholder, the latter will be granted the advantage of easy sale terms, which are however not closely defined. There are restrictions on the privatisation of leased out assets which are integrated into the overall production process of an enterprise or plant. However, the latter are not specified. Enterprises which are privatised after the privatisation programme has started have not the same advantages. Leasing is not understood as divestment of user rights and subsequently not seen as a privatisation method. New legislation on leasing was only passed in November 1994 and required supporting legislation, schemes and rules are still missing.³²

The sale of leased enterprises to their leaseholders causes relatively low transaction costs, as administrative and realignment costs are low. The economic competence of the leaseholders can also expected to be high. However, there might be public criticism as most leaseholders were reportedly members of the nomenklatura.

³² See also section 4.4.

(5) *The voucher programme*

The draft programme also envisages a mass privatisation programme in form of free distribution of dematerialised privatisation vouchers or 'shares' as termed in Azerbaijan, in which 42% of all assets scheduled for privatisation should be privatised.³³ The goal for the voucher scheme programme is an equal starting point for the entire population.³⁴ This gesture of equity can be understood as a strategy to sell broad privatisation. Considering the value of each share, the upkeep of insider control due to wide dispersion of ownership, and the prevalent disparity of wealth, the voucher scheme hardly leads to an equal starting point in practice. Every citizen is allocated a special privatisation account in a savings bank with AzM4000 (equalling US\$4 in June 1994).³⁵ In order to prevent speculation, the privatisation vouchers are not transferable, can only be used for privatisation purposes, and cannot be paid out in cash. In a labour collective buy-out up to 50% of the price can be paid in vouchers. State and private investment funds are expected to be established in which citizens can invest their vouchers. So far, no regulations nor regulating bodies have been established for such funds. Thus the protection of shareholders of newly emerging investment funds is doubtful.

The level of transaction costs of this free transfer scheme can be expected to be very high as discussed in section 3.3.3. This will be particularly the case in Azerbaijan with its practically non-existent capital markets, fragmentary legal framework and weak law enforcement agencies. As mentioned above, the voucher privatisation scheme can be expected to reinforce insider control and will hardly initiate industrial restructuring.

³³ See section 3.3.3 for an extensive discussion of theoretical and empirical issues of voucher privatisation schemes.

³⁴ For an evaluation of the equity argument, see section 2.4 in this volume.

³⁵ The value of each voucher is calculated as follows: the total value of state assets in Azerbaijan (except for land, state housing and Sovkhozes) amounted to AzM 103.8 billion (in prices of 1 January 1993). 63 to 65 percent of these assets are scheduled for privatisation of which 42% are to be privatised through the voucher scheme (equalling 28.1% of total state assets), amounting to AzM 4000 per person.

(6) *Insiders' benefits*

It is important to note, that managers are not at all mentioned in the draft programme. Only the labour collective is referred to. In all privatisation methods except for the voucher scheme which is based on investment funds the position of the labour collective towards insiders is significantly strengthened by the programme. However, it can hardly be expected that insiders are going to lose the upper hand. First, in the foreseeable future there are only small and medium sized enterprises of the light and wood industry and the agro-industrial complex scheduled for privatisation. In the first year this will only affect enterprises in the provinces, which have often ceased production and are in many cases heavily dismantled. The other group of enterprises prioritised are enterprises which are bankrupt and due to be liquidated. In all these priority groups significant investments are required which hardly will be forthcoming from the labour collectives. Illiquid capital markets and the fragile banking system are also unlikely to secure these investments. Second, as discussed above, even if the process of corporatisation is initiated, it is unlikely that it will be able to limit insider control. Third, as shown above, the voucher scheme which is to affect 42% of all state assets scheduled for privatisation is also unlikely to challenge insider control.

5.5.3 The proposed timetable of privatisation

Table 5-29 presents the very ambitious timetable of the 1994 draft privatisation programme. None of the set objectives has been achieved. Due to both resistance by the industrial bureaucracy and the disorganised approach it was not possible to conduct a full inventory of all enterprises. Equally the process of unbundling the enterprises of their quasi-holding structures has not even been seriously attempted. The ASPC was not able to set up its regional networks due to regional resistance and lack of resources.

Table 5-29: Timetable of the draft privatisation programme of 1994

No.	Measures	Responsible authorities	Proposed deadline	Progress made before February 1995
1.	Establishment of legal framework	<ul style="list-style-type: none"> • Supreme Soviet • Presidential Apparatus • Council of Ministries • ASPC 	1994	<ul style="list-style-type: none"> • Law 'On Privatisation of State Property in the Republic of Azerbaijan' adopted on 7 January 1993 • 1993-94 Privatisation Programme has not been approved by Supreme Soviet
2.	<ul style="list-style-type: none"> • Registration of SOEs • Inventory • Valuation 	<ul style="list-style-type: none"> • ASPC • AME • ASSC • Tax Inspectorate • branch ministries • concerns • production • associations • enterprises • local government 	1994	Neither an inventory nor a valuation of SOEs has been completed.
3.	<ul style="list-style-type: none"> • Establishment of regional network of offices of the ASPC • Ensuring co-ordination between local executive powers and ASPC 	<ul style="list-style-type: none"> • Council of Ministries • ASPC • AMF • local government 	1994	A regional network of offices has not been established so far.
4.	<ul style="list-style-type: none"> • Processing of all data and information relevant for the privatisation process 	<ul style="list-style-type: none"> • ASPC • legislative bodies 	regular period	
5.	<ul style="list-style-type: none"> • Training and staff development • Communications and public relations 	<ul style="list-style-type: none"> • ASPC • Ministry of Education 	1994-1995	<ul style="list-style-type: none"> • No assessment of training requirements has been accomplished. • Only top level managers were considered for training. • The publicity department consists of two employees.
6.	<ul style="list-style-type: none"> • Study tours for top management abroad in order to draw upon the experience with other privatisation processes (funded by UN- and EU-organisations) • Attracting foreign investments 	<ul style="list-style-type: none"> • ASPC • AMF • AME 	1994-1995	No visits have been undertaken.
7.	Diminish the control rights of ministries, concerns, central headquarters and other administrative bodies over SOEs through commercialisation	<ul style="list-style-type: none"> • constitutional court • Council of Ministries • ASPC 	1994	The law "On Joint-Stock Companies" has been adopted in November 1994. However, there have been no significant changes in corporate governance of SOEs
8.	<ul style="list-style-type: none"> • Unbundle enterprise units of associations and corporations • Registration of charters of newly independent enterprise units 	<ul style="list-style-type: none"> • SOEs • associations • enterprise registration authorities 	mid-1994	Attempts to unbundle the industrial giants and associations have been unsuccessful
9.	Publicity work	<ul style="list-style-type: none"> • ASPC • radio and television broadcasting organisations • Ministry of Publication and Information • press 	regular period	According to a survey conducted in July 1994 by the Centre of Opinion Polls and Prognosis of the Azeri Supreme Soviet, only 20% of the respondents were satisfied with the information available on the privatisation process.

Source: ASPC

Concluding remarks

To summarise: the privatisation process has been so far pursued with limited political commitment. First, the legal framework of privatisation reveals many deficiencies. From the textual perspective, the main privatisation law requires clarification across a number of matters. Subordinate legislation referred to in the main privatisation law is often even not in draft stage. A privatisation programme has not yet been passed by parliament. The latter requires textual clarification in significant areas, as well as additional rules and regulations (e.g. regulations on auctions etc.). It appears as if both the framework law and the draft privatisation programme were purposely held vague in order to allow room for free interpretation once the programme is passed. Moreover, there seems to be fear that the more definite the programme is the less likely it will be to get it approved.

Second, major policy steps which have to precede the privatisation process (e.g. a social plan to mitigate undue hardship, adequate provisions for corporate governance, etc.) have not been taken yet.

Third, the ASPC appears as a body with little power, which hardly can impose any decisions and steps without the consent of powerful interest groups, e.g. insiders including the industrial bureaucracy and local authorities. So far they were not even able to conduct a registration and full inventory nor establish its own regional structures. However, through the privatisation programme they would have considerable discretion in decisions such as which privatisation method is going to be used, favourable payment modes for buyers, and tender conditions, etc. This discretion is open to abuse. Thus one can understand that existing institutions, e.g. ministries and local authorities, feel themselves challenged by the establishment of a new authority and a competitor for scarce informal income.

The assessment of the draft privatisation programme promises little impact on both static and dynamic efficiency of significant enterprises. Moreover, the programme will hardly set an end to the long battle over the distribution of property rights over the enterprises. First, the planned voucher programme including the envisaged investment funds and privatisation through capital market

operations and auctions does not encourage conditions favourable to effective corporate governance and the initiation of industrial restructuring. A capital market and its institutions would still have to be established and are prone to be subjected to manipulation and outright fraud.³⁶

Second, privatisation through corporatisation makes favourable provisions for the labour collective. However, due to the poor financial institutions and the non-existence of capital markets it will be very difficult for the labour collectives to raise the funds to buy the controlling stock of their enterprises, let alone to carry out the necessary investments for restructuring. Moreover, considering the condition of most labour collectives, there is the danger that relatively unrestricted insider control will be the outcome of this way of privatisation.

Third, the enterprises in the industrial sector scheduled for privatisation in the foreseeable future are all insignificant for the economy. In case of the scheduled small scale privatisation, most businesses concerned (e.g. shops, kiosks) are already run privately with a formal or informal lease arrangement with the local authority concerned. Thus there will be little impact on the economic performance of these businesses and the only change will be the formal and informal arrangements between the authorities and the leaseholders. At the most, it will have an effect on the real estate market, as many businesses intend to sell their shops. Most of this small scale privatisation should therefore not be dealt with as 'enterprise privatisation' but rather as a matter of commercial property sale.

On the whole, the assessment of the plans and realities of privatisation shows little political commitment for the latter in Azerbaijan. Why is it that the privatisation process is so cumbersome in Azerbaijan? After all privatisation is the only official approach taken towards restructuring. The assessment of survey and interview material in the next chapter tries to shed some light on this question.

³⁶ See also chapter 3.

6. Privatisation in Azerbaijan: Attitudes, perceptions and expectations

Introduction

The survey and interview material presented here has been designed to provide empirical evidence concerning attitudes, perceptions, and expectations towards privatisation in Azerbaijan. The assessment of popular attitudes are important as they influence the climate that either upholds or hampers the process. Moreover, ultimately the implementation of privatisation will depend on the willingness and ability of parts of the public to participate in the new structures.

The analysis is based on a public opinion survey on privatisation conducted for the internal use of the ASPC and extensive open-ended interviews with stakeholders in the privatisation process conducted by the author during field visits between December 1993 and February 1995. The affiliations of the interviewees is documented in Table 6-25. The main themes covered in the interviews and by the survey are listed in Table 6-1 and presented below.¹

Expanding the data sources is done in the spirit of Bulmer (1993a: 10): '[...] different [research] methods are *complementary* to each other rather than in competition [...]' Qualitative data - often anecdotal and impressionistic - sheds light on the complex political and economic context and intricate patterns of political and economic interaction. A strong advantage of the sample survey is its generalisability.²

The public opinion survey on privatisation of the Publicity Department of the ASPC was conducted in June 1994. The author advised Ms Yavi, the manager of the publicity department, on the design of the survey.³ The population from

¹ In the following sections, participants of the survey are referred to as respondents, participants of the author's interviews as interviewees.

² For a more detailed discussion of the problems and merits of sample surveys see, for example, Bulmer (1993b), Stacey (1969), Stycos (1993), and Zarkovich (1993).

³ The survey was carried out by the Public Opinion Research Institute of the Supreme Council on behalf of the ASPC.

which the sample was drawn is based on the working population of the district of Baku. The sample was selected randomly using the following criteria for stratification. Respondents were to be proportionally distributed between different employment places (i.e. scientific institutions, factories, transport, trade and service sector) and age. Altogether the 800 respondents were questioned in 30 randomly chosen locations.

Table 6-1: Main themes of the interviews

	<i>Interview theme</i>
1.	Accessibility of information
2.	Attitude towards privatisation
3.	Attitude towards privatisation of enterprise employees
4.	Attitude towards speed of privatisation
5.	Attitude towards methods of privatisation
6.	Attitude towards participation of foreigners
7.	Attitude towards corporatisation
8.	Ownership potential
9.	Perceived obstacles to privatisation
10.	Expected 'winners' of privatisation
11.	Expected results of privatisation
12.	Expected personal consequences
13.	Perceived legitimacy of privatisation

Table 6-2: Affiliation of interviewees

Affiliation	Number
Presidential apparatus	1
Parliament	3
Council of Ministries	4
Ministry of Economics	6
Ministry of Finance	3
Privatisation Committee	8
Anti-monopoly and Entrepreneur Support Committee	1
Tax inspectorate	2
Concerns	6
Enterprises	21
Trade Union	5
Chamber of Commerce and Industry	1
Banks	3
Academia	5
Journalists	9
Total	78

6.1 The findings

(1) Accessibility of information

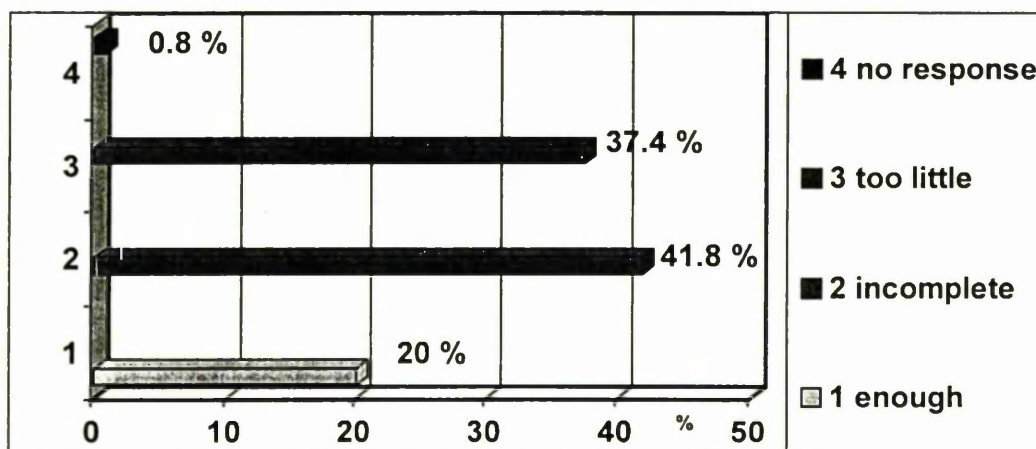
There has been a serious lack of information on the proposed privatisation programme. Only 20% of the respondents regarded the information dissemination as sufficient (see Figure 6-1). 33.9% of the respondents required basic information and 33.4% specific information (e.g. time schedule, auctions, employee benefits etc.).

Whilst quite a few interviewees had relative good knowledge of technicalities of privatisation (e.g. auctions, competitive tenders, valuation ,etc.), the majority had little knowledge and understanding of the theoretical underpinnings of privatisation and broader concepts of industrial restructuring and corporate governance. The theoretical concepts supporting the superiority of private ownership and the discussion on privatisation in other PCPEs and in the international literature was unknown even to academics.

Most of the interviewees did not have up-to-date information on the draft privatisation programme, although they could be regarded as stakeholders in a possible privatisation process. Employees of the AME, AMF, trade unions, and banks were not consulted on the draft of the programme. There was a need of information in specialised issues like the setting up of investment funds, corporatisation, and benefits of employees. However, it seemed that the official privatisation process was nowhere a priority concern.

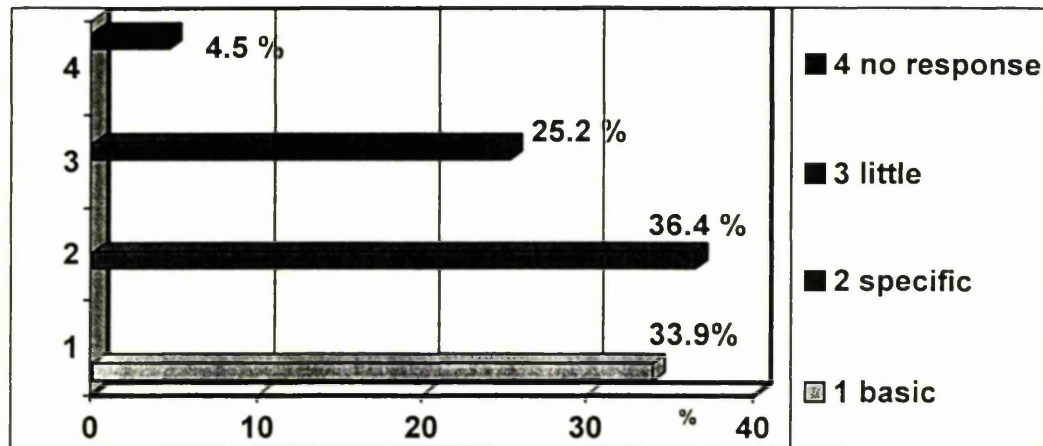
There was hardly any experience of other countries made public. Most of the interviewees had followed the Russian privatisation process and were familiar with the issues of the Russian voucher privatisation scheme, auctions, competitive tendering, MBO and ESOP schemes, corporatisation, and investment funds. However, they had little knowledge of the privatisation process in Kazakhstan or other FSU republics and PCPEs. There was however also resistance to being pigeonholed as 'PCPE' and there was doubt over how far the experiences of other countries could be transferred to the Azeri context. In particular, comparisons to Central Asian newly independent states were approached with some local chauvinism, i.e. Azerbaijan is regarded as less backward than these countries.

Figure 6-1: Availability of information



Source: Survey of the Publicity Department of the ASPC

Figure 6-2: Demand for information of respondents



Source: Survey of the Publicity Department of the ASPC

(2) *Attitude towards privatisation*

The survey results show that the population is divided on the question of privatisation with 39% proponents and 34.2% opponents (see Figure 6-3). However, the high number of 'undecided' also indicates that privatisation is for a significant part of the population not regarded as an issue of importance. It has to be noted that the result could have been different if the question had been divided between small and large privatisations. There is a large group of small business people who expect some advantages through the privatisation of shops, little workshops, etc. However, there seems to be far less support for the privatisation of large enterprises as reflected in Figure 6-4.

Many of the interviewees were in favour of some form of privatisation. However, they did not believe that large scale privatisation, as carried out in Russia, would begin in the foreseeable future. There was great reluctance over mass privatisation, because it was feared it could disturb the relative political stability. It was believed that the broad public is still devastated by the events of recent years: the Karabagh conflict, the break up of the Soviet Union, the debacle with the AzPF. The majority of the population was not regarded as prepared for the privatisation process as it symbolised a definite break with the past. Moreover, the fixation on the issue of privatisation was regarded as inadequate particularly in respect of large enterprises.

Many interviewees, most eminently in enterprises and concerns, were highly suspicious of the ASPC, which was regarded as the establishment of another central authority and thus another corrupt bureaucratic hurdle for economic activity. The existing bureaucracy was already regarded as enough. They had little faith in the expertise of the ASPC on the industries concerned and would have rather seen experts deal with the issue. Moreover, power struggles between competing bureaucracies and the ASPC would further paralyse any development.

Many distinguished between the privatisation of small enterprises (e.g. shops, workshops, restaurants, hairdressers) and large enterprises. They emphasised that these processes had to be carried out separately as different stakeholders were involved. Some even thought that these two types of privatisation were combined in order to gain popular support. This view is supported by the results of the survey concerning the speed of privatisation: 50.1% of the respondents favour privatisation in separate stages (see Figure 6-5).

Some interviewees suggested that none of the influential stakeholders had enough power to influence the privatisation process openly in their favour; thus they would rather stall it. The powerful interest groups (e.g. state companies, bureaucracy) were regarded to favour informal arrangements.

A few interviewees, mainly academics, did not agree with the 'wholesale' character of the mass privatisation programmes. They would rather like privatisation to be carried out selectively and embedded in a broad industrial restructuring programme. They regarded the privatisation of large enterprises as not feasible as the required funds for investments could not be raised privately. None of the interviewees of enterprises and concerns had any clear ideas on how their respective industries should be restructured after privatisation.

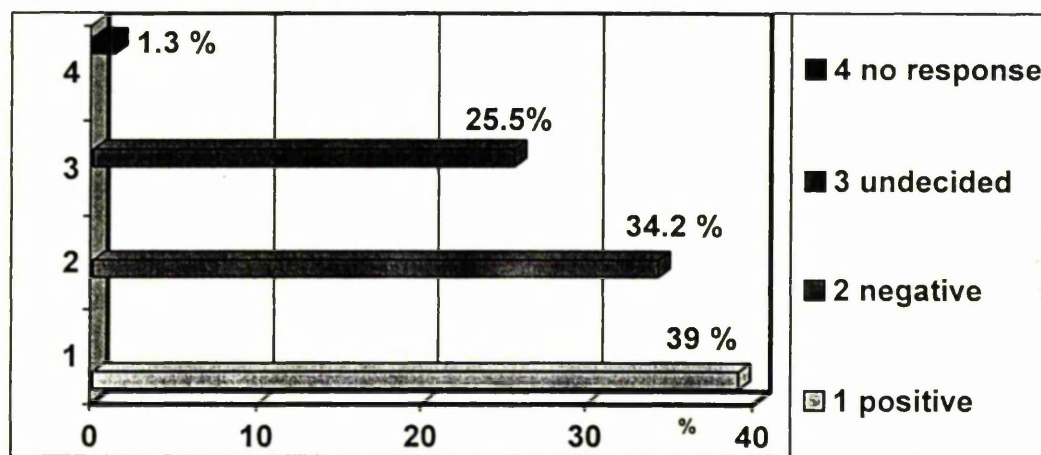
Privatisation was hardly regarded as an instrument for the establishment of better enterprise control mechanisms and the initiation of industrial restructuring. It was considered by its supporters as an unquestioned necessity on the path to a market economy and the break with the old Soviet economic system. Many saw privatisation as a means to adapt the de facto property rights structure to the de jure structure. They emphasised that privatisation would often be perceived as the

official sanctioning of long-term theft by nomenklatura and insiders. Thus, there would be a psychological barrier to accept this seemingly final verdict. The minority regarded it as measure to reduce the influence of the former nomenklatura, which was in any case regarded as impossible. The threat of privatisation was also seen as a means of the ruling elite to discipline other powerful interest groups.

Some interviewees even rated privatisation as mere internationally demanded prerequisite for gaining acceptance and support and therefore opposed it. Now that Azerbaijan had finally gained independence it should struggle for self-determination instead of giving in to international demands. After all, foreigners had their own agendas and had little interest in the future and well-being of the Azeris.

Many interviewees described the present ownership situation as a kind of stalemate from which no progress would be possible. Thus, measures had to be taken one way or another to clear the uncertainty over the future of the enterprises and create a situation in which restructuring is possible. However, the majority saw little significance in the official privatisation process. Many reckoned the process would be carried out more on an informal basis.

Figure 6-3: Attitude towards privatisation of respondents



Source: Survey of the Publicity Department of the ASPC

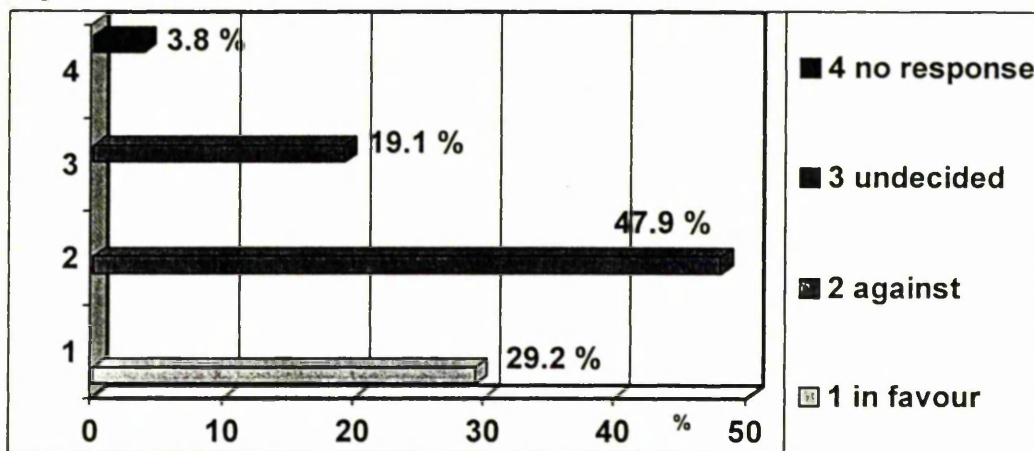
(3) *Attitude towards privatisation of enterprise employees*

The survey indicated vast resistance of employees against the privatisation of their enterprises (see Figure 6-4). Most employees seem to distrust the proposed labour collective friendly privatisation schemes.

Some interviewees suggested differences between various branches and enterprises could be expected. They expected that employees of small enterprises would be more prepared for privatisation than those of large enterprises. However, it would depend on other factors, most eminently the recent official and unofficial performance of an enterprise. They reckoned that many employees often hung on even to their unpaid jobs, with the hope of reward after the recovery of the economy. This reward could be jeopardised through privatisation.

Interviewees with trade unionist revealed that hardly any labour collectives speculated with a labour collective buy out. None of the labour collectives had developed their own reform concepts and programmes which could be implemented in their enterprises. The whole labour movement is poorly organised and fragmented. The old trade union structures have not been able to transform themselves into a forceful power.

Figure 6-4: Attitude towards privatisation of enterprise employing respondent



Source: Survey of the Publicity Department of the ASPC

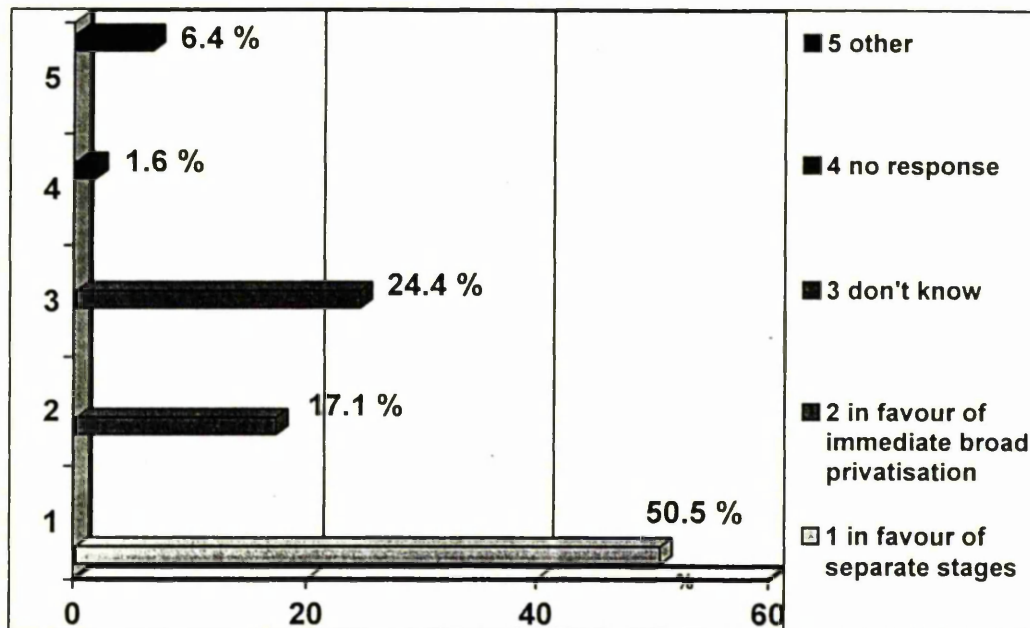
(4) *Attitude towards speed of privatisation*

As mentioned above the majority of respondents favoured a privatisation in separate stages (see Figure 6-5). 17.1% are in favour of immediate comprehensive

privatisation which indicates a plea for fundamental change. Again, the large percentage of 'don't know' indicates that the issue of privatisation is not considered important by a significant section of the population. Most frequent responses under the rubric 'other' were that experiences of other countries should be considered and that small enterprises of the service sector should be privatised first. Some interviewees in favour of privatisation thought that a delay would prolongue the uncertainty over the future of the enterprises and would intensify the power struggle between different stakeholders.

The lack of preparation of accompanying measures was widely criticised, particularly the lack of an adequate social plan to mitigate undue hardship and the inappropriate measures taken for the valuation of the assets. It was generally agreed by proponents that any acceleration of privatisation should not be carried out at the expense of preparation. Opponents of privatisation also criticised the lack of overall sectoral plans and strategies.

Figure 6-5 : Attitude towards speed of privatisation



Source: Survey of the Publicity Department of the ASPC

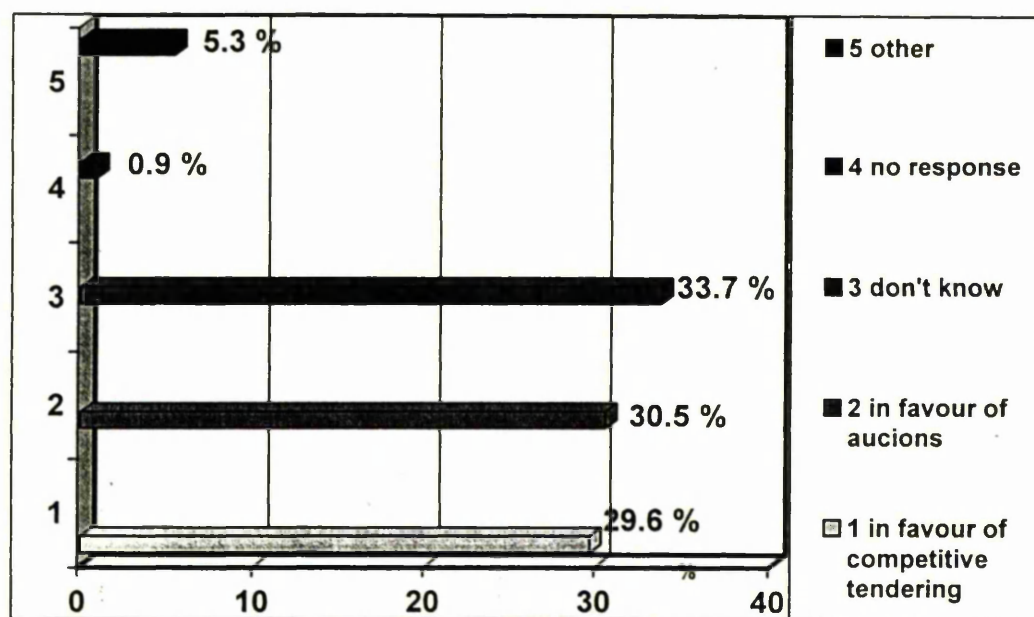
(5) Attitude towards methods of privatisation

Auctions were slightly more favoured than competitive tenders in the sale of small enterprises (see Figure 6-6). Most respondents were worried about the

transparency of tenders, and regarded them as more prone to corruption. The interviews also reflected this sentiment. Other opinions were mostly disagreement with sale or that lower income groups should be considered more.

Most interviewees took political feasibility as the main criterion for their evaluation of privatisation methods. However, the majority favoured the sale or give-away to the labour collectives as the most legitimate and promising method. The latter would match the inherent Soviet mentality more and was understood as the legitimate successor of the centrally planning regime. Corporatisation and subsequent sale and give-away of shares were regarded as the most politically feasible method as explained below. The majority of interviewees had no clear preferences concerning small enterprises.

Figure 6-6: Attitude towards auctions in comparison to competitive tenders in the sale of small enterprises



Source: Survey of the Publicity Department of the ASPC

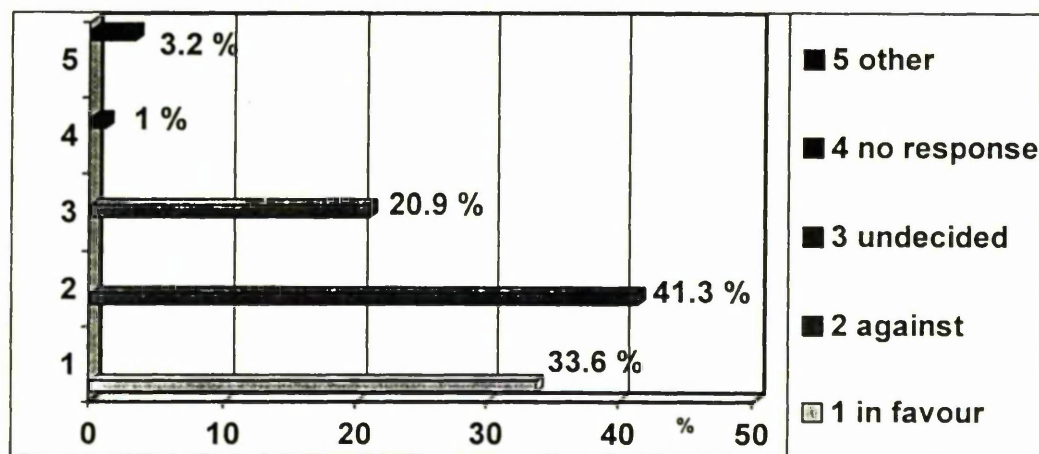
(6) Attitude towards participation of foreigners

The result of the survey show that opinion on foreign participation in privatisation is very divided in Azerbaijan (see Figure 6-7). 41.3% percent of respondents were against foreign participation and 33.6% in favour. However, the high number of undecided respondents indicates an ongoing debate. Most of the proponents

emphasised the employment and transfer of technology foreign involvement would bring. Others who welcomed foreign participation would still like Azeris to be favoured in the privatisation process. Some stressed that sales to foreigners should be restricted to enterprises without strategic importance.

The attitude of the interviewees towards foreign participation was overwhelmingly positive. Foreigners including the Azeri expatriate community could revive the economy and would moreover not be exposed to the same institutional constraints as domestic investors, i.e. corruption and bureaucratic obstacles. It was generally agreed that foreigners should be attracted through favourable terms to branches and enterprises in which Azerbaijan lacked expertise and investment capacity. There was some sentiment that small enterprises should be kept a domain of domestic investors. However, the majority overestimated the extent of foreign participation. They expected outside investors and supranational credits to take a leading role in the restructuring of the entire economy including sectors outside the petrol-related industries. Most hoped that foreigners would buy up to one third of all medium and large sized enterprises, despite their knowledge of the current dearth of foreign investment. Sale of enterprises to foreigners was regarded as independent from the general privatisation programme and it could be initiated in case-by-case negotiations.

Figure 6-7: Attitude towards participation of foreigners



Source: Survey of the Publicity Department of the ASPC

(7) *Attitude towards corporatisation*

The survey showed a polarisation in attitudes towards corporatisation: 42.8% were against whilst 37.7% in favour and with 18.1% there was a relative high number of undecided (see Figure 6-8). This result was also reflected in the estimation of the opinion trends by the interviewees.

Some journalists suggested that joint stock companies had a negative image as people suspected that their formation was a pretext to preserve old property rights structures. They expected that corporatisation would even increase the present principal-agent problems, as it would offer little by way of control mechanisms. Shareholder meetings were regarded as a poor means of control, as shareholders and investment funds would not pose a credible threat. The latter would be hardly experienced and familiar enough with the commercial, financial and managerial aspects of the complex organisations,⁴ particularly, as it could be expected that the now quasi-holding companies would transform themselves into joint stock companies. Moreover, all these entities are de facto monopoly producers, which required additional attention. Corporatisation would have little effect on inherent inefficiencies. More far-reaching organisational restructuring would be needed.

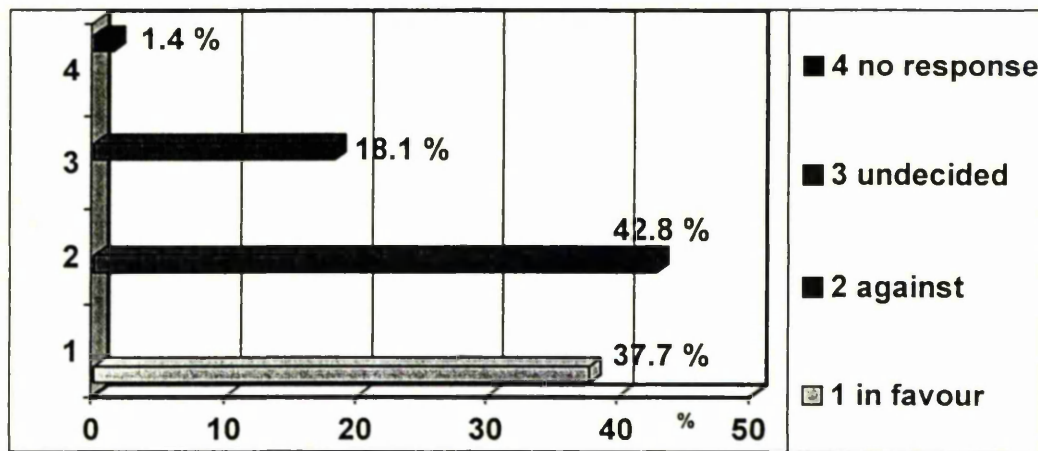
Particularly young interviewees regarded share ownership and the stock exchange as a prerequisite of modern capitalism. For them it was almost a question of national pride to have such institutions which symbolised to them the final stages of economic development.

Some interviewees were suspicious of the emergence of the security markets and instruments which would follow corporatisation. They thought that most small investors were mainly attracted by the windfall gains that these new institutions would make possible. This short-sighted speculative behaviour was not regarded as a sound basis to come out the general economic crisis. The stock exchange and investment funds were compared with the charity organisations mentioned in section 4.5.

⁴ Another aspect mentioned for minority shareholders was that there would be cultural and sociological barriers in opposing powerful previous nomenklatura members.

The majority did not see corporatisation as an effective means of increasing the discipline of managers. However, corporatisation and the subsequent sale and give away of shares was generally regarded as the only political feasible method of privatisation of medium and large sized enterprises, as in case of initial wide dispersion of shares public protest would be limited without upsetting the status quo of insiders and the industrial bureaucracy.

Figure 6-8: Attitude towards corporatisation



Source: Survey of the Publicity Department of the ASPC

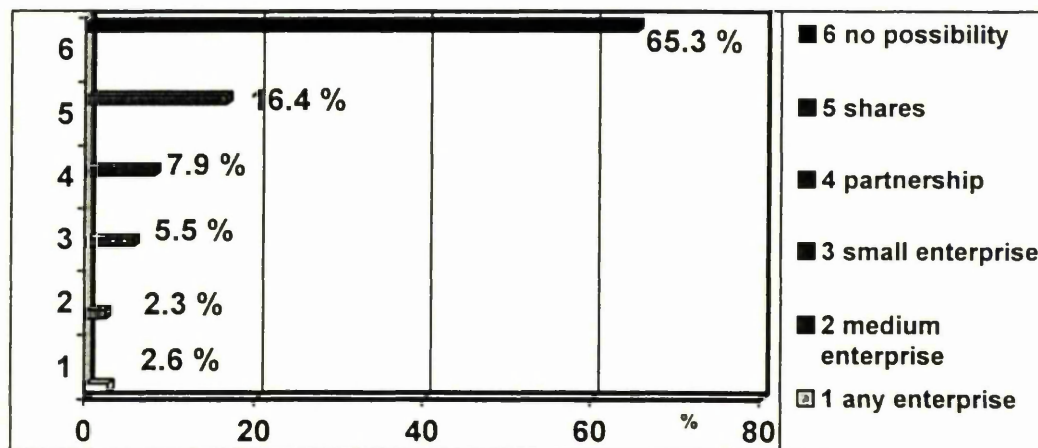
(8) Ownership potential

The result of the survey reflects the polarised wealth distribution in Azerbaijan (see Figure 6-9). Whilst 65.3% of the respondents saw no possibility for themselves to participate in the privatisation process, due to lack of financial resources, 2.6 percent saw themselves as able to buy an enterprise. Between these two extremes only 5.5% expected to buy a small enterprise and 16.4% could only imagine being able to buy shares preferably in enterprises in which they work.

The interviewees assessed the ownership potential of the population as in the survey. Many interviewees estimated the ownership potential of former nomenklatura members and nouveau riche to meet some of the needs of the required investments. However, political and institutional constraints would prevent them from becoming more active. The proposed amnesty to Azeris who are willing to repatriate their illegally acquired funds, and hence legalise their theft retrospectively, was welcomed as it was hoped it would bring more stability and

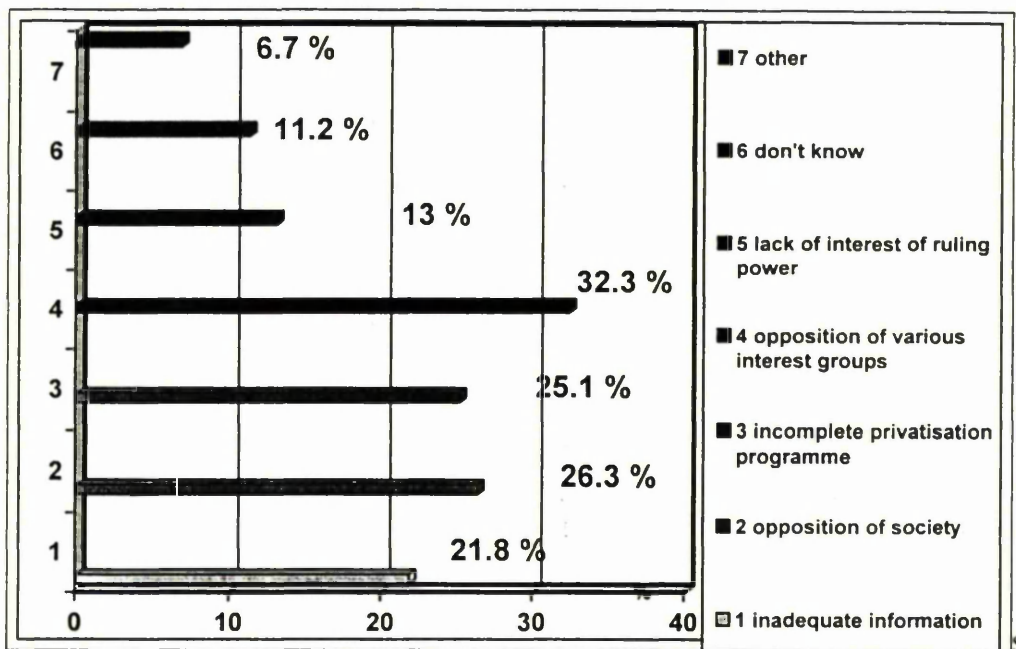
vital reinvestments. It was expected to be a long process until these groups would engage in production.

Figure 6-9: Self-assessed ownership potential of respondents



Source: Survey of the Publicity Department of the ASPC

Figure 6-10: Perceived obstacles to privatisation



Source: Survey of the Publicity Department of the ASPC

(9) *Perceived obstacles to privatisation*

The results of the survey were also reflected in the interviews (see Figure 6-10). 32% made the opposition of various interest groups responsible for the halt in

privatisation; this was also the impression of most interviewees. Most interviewees believed that the ruling power had no real interest in the privatisation process partially because they feared the opposition of powerful interest groups. Some believed that the ruling elite would fear interest groups gaining power through privatisation. In the survey only 13% of respondents saw the lack of interest of the ruling power as a major factor. The local authorities were identified as the significant power against small privatisation. The industrial bureaucracy often paired with insiders, i.e. managers of the quasi-holding structures, were regarded as the main driving force against the planned privatisation of medium and large enterprises.

26.3% saw the opposition of society as a main obstacle. And 21.8% saw inadequate information on privatisation as a reason. Figure 6-1 and Figure 6-2 confirm the lack of information on privatisation. So far there has been no organised public protest against privatisation. Considering the prevailing apathy and resignation over politics, the broad public has presently little influence on the decision makers.

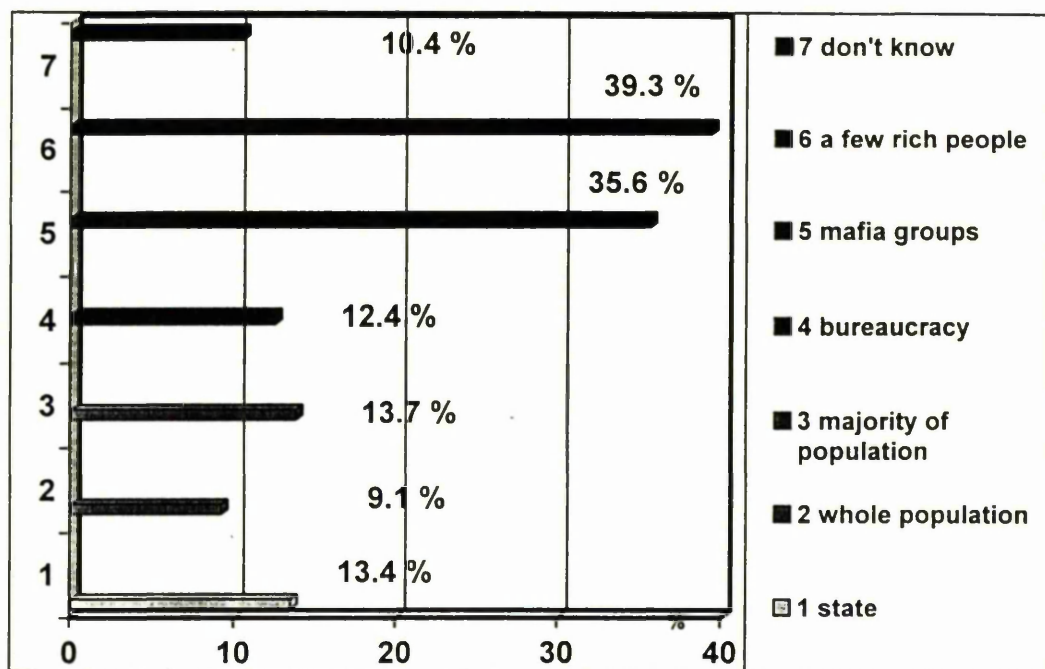
Other opinions of the respondents (6.7%) were: (1) that the discussion over privatisation was not adequate until the liberation of occupied territories; (2) that a comprehensive industrial policy programme is needed in which privatisation could be embedded; and (3) that privatisation to the labour collectives would be a way of avoiding obstacles to privatisation. The reference to the occupied territories was also made by many interviewees. As mentioned before, many interviewees did not see privatisation in the context of industrial restructuring. However, they saw the reduction of the uncertainty concerning the future property rights arrangements of the enterprises as a precondition for new investments. However, they did not believe that the required investments in large enterprises could be raised privately. They regarded the state as too weak to carry out an industrial policy programme successfully.

(10) Expected 'winners' of privatisation

The majority of the respondents believed a few rich people and mafia groups to be the 'winners' of privatisation (see Figure 6-11).⁵ 12.4% assumed the bureaucracy to profit from privatisation. This is very likely because of the expected corruption in the process. 13.4% saw the state profiting from privatisation, presumably because of the privatisation proceeds. Only 13.7% believed that the majority of the population would also have some benefits from privatisation and 9.1% presumed this for the whole population.

Most interviewees expected only a minority to benefit directly from privatisation. However, the latter was regarded as unavoidable sooner or later. Privatisation proceeds were regarded as insignificant. Some implied that informal payments to bureaucrats involved in privatisation could be expected to be high.

Figure 6-11: Expected 'winners' of privatisation



Source: Survey of the Publicity Department of the ASPC

⁵ Here it is difficult to assume a universal demarcation of the term 'mafia'.

(11) *Expected results of privatisation*

The following answers were given most often in the open-ended question of which results the respondents expected from privatisation:

- mass protest, famine, beggars, terror, crimes;
- emergence of the classes of 'have' and 'have not';
- anarchy, corruption, nepotism;
- problems will arise, (1) if there is no law on social protection and a provision of a social safety network; (2) if there is no proper legal framework for privatisation and if implementation mechanisms are not adequately prepared; and (3) if information is not easily accessible;
- first the lost territory should be liberated back, then privatisation can start;
- large percentage of population has no understanding of privatisation and its implications;
- the emerging struggle over wealth of mafia groups and various other interest groups will further paralyse economic recovery;
- money can ruin people, injustice will take its course.

There was a wide range of answers on the question of how far privatisation would affect political stability. Similar to the survey respondents, some interviewees were worried that the privatisation process could disturb the present relative political stability. They feared that once it began it could escalate into a fierce struggle over resources. Others believed that unless the outcome of privatisation would be predetermined with the approval of the different powerful stakeholders, it could not begin and hence there could not be any unexpected political conflicts. Few implied that the real distributional struggle had already been settled and it was only a matter of lack of interest of the ruling elite that the official privatisation had not started yet.

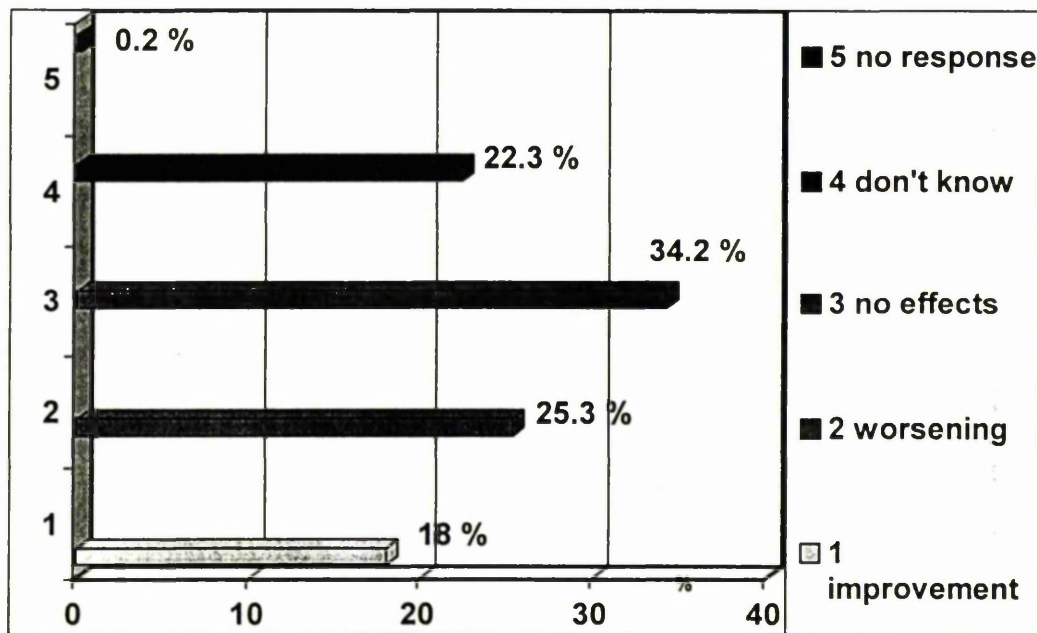
Concerning the economic situation, most did not expect further deterioration due to privatisation. However, significant changes in the organisational structure of enterprises and the initiation of industrial restructuring were not awaited either. The majority of interviewees expected the process of change to take a long time. It was often assumed that small scale privatisation would have more positive effects by introducing some dynamics.

(12) Expected personal consequences

In comparison to the overall evaluation of expected outcomes of privatisation, the majority of respondents did not have any expectations concerning their personal consequences (22.3%) or expected no effects (34.2%) (see Figure 6-12). Most interviewees also expected little effect of privatisation on the majority of the population. After all, most enterprises were already now not working and only sporadically paying wages. However, in the long run they expected the employment structure to change and predicted lay-offs in the public administration as well as in industry. For employees of the trade and services sector they predicted an improvement. These views were also reflected in the survey: 25.3% expected their situation to worsen and 18% foresaw an improvement of their situation.

Some interviewees stressed the psychological threshold concerning privatisation, as the latter would symbolise the ultimate break with the past.

Figure 6-12: Expected consequences on respondent's personal life



Source: Survey of the Publicity Department of the ASPC

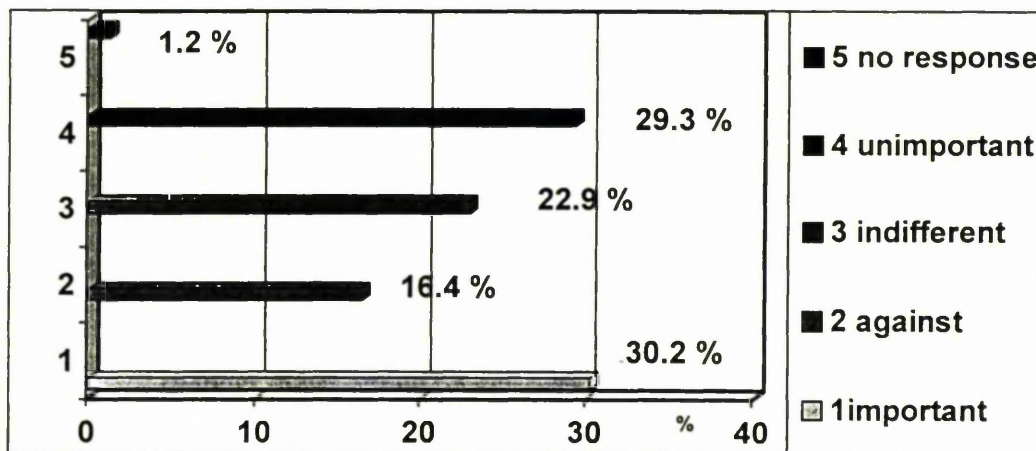
(13) Perceived legitimacy of privatisation

Many interviewees were in favour of a referendum on privatisation as such a significant step would have to be legitimised. This view was shared by 30.2% of the respondents.

The majority predicted that a referendum would not make any difference to large parts of the population who were resigned to having no faith in the state. This was also reflected in the survey results: 29.3% regarded a referendum on privatisation as unimportant and 22.9% were indifferent (see Figure 6-13).

Similarly some were even against a referendum: first, because they suspected that it was impossible to conduct a fair referendum; second, because they believed that large parts of the population had no information to form an opinion on privatisation, and, third, because they regarded it more as an issue of the labour collectives to decide.

Figure 6-13: Attitude towards a referendum on privatisation



Source: Survey of the Publicity Department of the ASPC

Concluding remarks

Both survey results and interviews revealed a rather divided attitude towards privatisation. There was more acceptance for small scale privatisation than large scale privatisation. Little impact on enterprise performance was expected from the latter and its implementation was hardly believed to be in the foreseeable future. The majority of respondents believed privatisation would either have no or

worsening personal consequences. The overall consequences of privatisation were predicted to be grim.

It is important to note that none of the interviewees saw privatisation as a means to initiate fundamental restructuring and establishing effective corporate governance structures. Privatisation proponents saw it as a means to reduce the uncertainty over the enterprises and make 'a new start' possible. However, whilst some of the required investments could be covered by the mostly illegitimate wealth of some rich, hardly any interviewee saw any major investments from the private sector forthcoming. Others saw the existence of share markets and share-ownership as prerequisites of modern capitalism and thus a necessity for any developed country.

In both the survey results and the interviews the distrust of the state and resignation over politics in general was striking. Policies and new institutions like the ASPC are viewed with suspicion and suspected of hidden opportunistic intentions. Quite a few regarded the whole privatisation process as being already informally completed.

Many respondents of the survey chose the option 'don't know' and 'undecided' as their answer on many questions, which indicates widespread uncertainty and indifference about the privatisation issue. This indifference may reflect the universal resignation over politics and the slow and tentative progress in privatisation. This was also displayed in the interviews in which the majority did not expect large scale privatisation in the foreseeable future.

Many interviewees hinted at ongoing power struggles over public assets and ultimately resources with which the privatisation process is intrinsically intertwined. The intervention of various interest groups was mentioned as the main obstacle for the privatisation process. The next chapter looks at this underlying power struggle over property rights more closely.

7. The political economy of privatisation in Azerbaijan

Introduction

In previous chapters the institutional background and the privatisation process itself have been illuminated. Incorporating the previous analysis, this last chapter evaluates the privatisation process within the framework of institutional change based on Libecap (1993), which has been adapted and extended to suit the context of privatisation issues in PCPEs.¹

The question raised is, why is it that the existing property rights structure cannot easily be replaced with one which is more conducive to economic recovery as some proponents of privatisation would suggest? The answer lies with the bargaining parties involved, the range of institutional options the latter are facing, and the complexity of factors influencing the calculation of private expected gains from alternative institutional forms. As discussed before, contracting for property rights is an extremely complex process and it is hardly possible to calculate the net gains of all institutional options for every single contracting party. However, in the following, tendencies of the contracting process are pinpointed by the identification of the contracting parties and the general factors which influence an agreement to the adjustment of the property rights structure.

The first section analyses the key players in the Azeri contracting process, followed by an evaluation of factors influencing the likelihood of agreement on institutional change. In the final section the actual process of contracting for property rights in Azerbaijan is evaluated in the light of the analysis of the previous chapters.

¹ See section 2.3 for a detailed account of the framework of institutional change.

7.1 The key players

In the context of Azerbaijan seven categories of interest groups can be isolated which play a significant role in the bargaining process for institutional change. The categories, defined below, are (1) industrial bureaucrats, (2) insiders, (3) nouveau riche, (4) politicians, (5) bureaucrats, (6) workers, and (7) foreign organisations. This categorisation certainly simplifies the situation as these groups are often not so rigid. For example, one cannot draw a clear line between politicians, insiders, and bureaucrats, as captains of industry are part of the political elite and as such hold important political positions. Nouveau riche have often emerged from the political establishment or have good contacts to, and working relationships with, insiders through family relations or otherwise. Patronage networks and other forms of coalitions consist of members from all these different groups.²

(1) Industrial bureaucrats

As described above, already in the Perestroika period, branch ministries and their republican subdivisions gained significantly in power and unchallenged control over their industries. This process was continued in Azerbaijan after independence, when former republican branch ministries and republican subdivisions of all Union branch ministries altered their legal status into that of concerns and associations (i.e. groups of affiliated companies).³ As stated above, nearly the entire production sphere is organised into fifty such quasi-holding companies. The upper echelons of these superstructures, i.e. management of concerns and associations are here defined as industrial bureaucracy. Previously in this volume this group has been subsumed under the label of 'insiders'; in the analysis of the contracting process, a more differentiated view has to be taken. As described below, there is a potential conflict of interest between the industrial bureaucracy and insiders aspiring for a higher share of the mostly informal residual of their enterprises. However, such conflicts have been rather minor, as

² For a more detailed discussion of the role of patronage networks in PCPEs, see section 2.1.

³ See section 4.3, for details on this development in Azerbaijan.

both groups are closely intertwined through patronage networks. The size of the industries is also relative smaller than in Russia and other PCPEs and they are almost entirely geographically concentrated around the capital Baku, which simplifies control through the industrial bureaucracy. Thus, the industrial bureaucracy in Azerbaijan has captured de facto controlling rights of their enterprises, and their interests are strongly represented in corporate strategic decision-making. They represent vested interests with significant bargaining power. Due to their well-established ties to the political establishment via patronage networks, the industrial bureaucracy has a relative advantage in political lobbying with other contracting parties.

(2) *Insiders*

The term 'insiders' refers here to managers of SOEs at plant level. The rigid but informal power structures in Azerbaijan reinforce the dependency of insiders on the industrial bureaucracy. The latter grant protection against unwanted reforms and provide scarce resources. Insiders are a very heterogeneous group in terms of political and economic power. They include managers of the oil industry, investment-starved light industry, etc. Their bargaining power depends on several factors, most importantly on the size of the enterprise, its potential viability, the significance of the goods produced for the economy, and the managers' links to the wider establishment. Managers of the oil industry, for example, are more influential as their enterprises mostly have a constant cash flow. Managers of potentially viable enterprises might have a stronger incentive to accept institutional change than those who depend wholly on rent-seeking activities. There is a fierce competition between all insiders for scarce state resources.

(3) *Nouveau riche*

The term nouveau riche describes here those economic actors who gathered considerable wealth mostly through illegal activities and mainly in trade and, to a

little extent, financial services,⁴ but who are not directly affiliated to insiders. The so called 'Aliverji' (Buyer-sellers) profited from the disintegration of the Soviet Union and other Comecon states and their control mechanisms and are involved in activities from trading in imported consumer goods to trading in state assets (e.g. metals and other resources) obtained at low prices, etc. Many also specialised in the buying and selling of household goods, valuables, and flats of Russians and others ethnic minorities emigrating and others who lost out in the transition. These trade activities are carried out largely and on a very small scale, i.e. on the so-called 'ant principle'.⁵ These nouveau riche have accumulated significant financial means in a relatively short time, and are potential investors for industry.⁶ However, they have little experience in industrial production. Moreover because of given institutional deficiencies, they have so far not articulated any strong interest in long-term high investment projects.

(4) Politicians

Despite the high turnover of newly founded political parties and politicians in Azerbaijan the political system is still predominated by the old Nomenklatura. The majority of politicians have previously served together in the Communist Party or the Komsomol organisation. Moreover, most politicians started out during the Aliev reign (1969-1982) and are therefore well entrenched in old patronage networks. As anywhere else, politicians in Azerbaijan are seeking to maximise votes and other forms of political support. Thus, they are receptive to influential and potentially influential interest groups. Vested interests are very likely to have the upper hand in political lobbying due to their resources and established networks. Thus, there is a strong incentive for politicians to maintain

⁴ Financial services include more established banking as well as loan sharks and the so called 'charity saving organisations' which took on household savings, against extremely high monthly interest-pay outs and provision of imported consumer goods and food stuff. See also section 4.5.

⁵ 'Ant principle' in Azeri refers to those traders who drive to Russia or Turkey with their Ladas or little lorries and fill them up with goods or fly on a charter flight to Dubai and bring back most of their merchandise as hand luggage.

⁶ Even in Soviet times there had been 'Aliverji', i.e. traders. Trading however, was not socially accepted and therefore hidden. Many of the traders hold considerable accumulated wealth from Soviet times and thus could be regarded as 'vieux riche'.

the status quo (cf. Libecap 1993: 17). However, due to the severe uncertainty, a forward-looking politician certainly cannot ignore newly emerging interest groups, and they will carefully try to balance out competing demands. According to the shifts in relative political strength, new political coalitions accommodating wider interests are likely to emerge. At this point, one has to emphasise that politicians' positions in Azerbaijan often rest on very fragile alliances due to weak judiciary and executive powers. Every politician is permanently sitting on an ejection seat. Thus even if he/she has the best intentions, he/she has to give in, to a certain extent, to the pressures of powerful vested interests for their own survival.

(5) *Bureaucrats*

'Bureaucrats' are part of the establishment and, like politicians, there has been a remarkable continuity from the Soviet era. However, their positions are less touched by political change, as they are not directly at the forefront of politics - politicians might come and go but policemen and tax inspectors will stay.

Due to the systemic changes in Azerbaijan, the old administrative structure does not match the requirements of the newly arising market environment. The functions of large parts of the administration are obsolete. For instance, a Ministry of Material Resources seems to have little function outside a planning environment. Often functions are also duplicated if not even triplicated on various levels of political apparatus.⁷ Official wages cannot secure the accustomed living standard under 'Realsozialismus' and are even too little to survive. Most administrations have formally and informally found themselves new functions and new sources of income, as state resources were more and more withdrawn. They have often developed parasitic relationships both to insiders and nouveau riche. However, parts of the bureaucracy are under constant threat of being laid off. Despite the numbers of bureaucrats, there is a lack of staff skilled and experienced in the new requirements of the changing environment (e.g. new investment appraisal, project management, budgeting, accounting methods, etc.). Instead of reforming or abolishing old bureaucratic

structures, it is sometimes easier to establish new structures, e.g. instead of reforming the Ministry of Economics, the ASPC and the AAESC were set up. These new structures challenge income sources of old administrative bodies.

Bureaucrats are again a very heterogeneous group with varying political influence. Often they are competing over spheres of influence, i.e. sources of corrupt income, as in, for example, the authority to issue export licenses, etc. On the whole, the interest of large parts of the bureaucracy lies in maintaining the status quo. However, the newly emerging ASPC and parts of the other administrative bodies might be in favour of privatisation as it would provide them with short-term informal income.

(6) Workers

Workers have been the clear losers of the transition period. They have been stripped of all their privileges, e.g. job security, extensive benefits in kind and social services. Their influence on institutional change varies between different industrial branches, but is continuously decreasing. The trade union movement in Azerbaijan has not caught up with the new requirements of the transition period, if not to say the dramatic economic decline has left it paralysed.⁸ The old official trade unions and their leaders have often been well-integrated or absorbed into the political establishment and are, therefore, captured by insider interests. Due to the economic crisis, unionisation levels have often declined and the union movement has become increasingly fragmented. There is a desperate lack of viable reform concepts on which the labour movement could develop programmes. On the whole, workers are very weak players for the foreseeable future. The tendency is for them to support insiders.

(7) Foreign organisations

The classification 'foreign organisations' comprises foreign investors as well as international and supranational organisations (e.g. IMF and IBRD). Although

⁷ See section 5.1 for an account of the situation of the state apparatus in Azerbaijan.

⁸ A similar account is given for the situation of the labour movement in Russia, see Kagarlitsky (1995b) and Mandel (1995a and b). For an account of Poland, see Sylwestrowicz (1995).

foreign investments have been rather meagre except for the oil extracting industry in Azerbaijan, a large part of the domestic contracting parties are eager to obtain foreign involvement.

Due to the expected oil boom, Azerbaijan constitutes a potentially viable market for foreign economic agents. Hence foreign investors are mainly interested in foreign trade liberalisation, foreign investment laws that secure their investments and repatriation of profits, and 'political stability' in the sense that their investments are not threatened by nationalisation and their trade and production interests are protected. They are ready for all sorts of coalitions with domestic interest groups.

International and supranational organisations promote their structural reform, macro-economic stabilisation and foreign trade liberalisation packages.⁹ These austere policy prescriptions are spurred in Azerbaijan by stabilisation funds, soft credits, and other financial incentives. The funds provided may often be insignificant for the overall economy, and its agents. However, they are noteworthy enough for bureaucrats and politicians. Often the author could witness the sheer excitement and the explosion of report writing in almost the whole administration of Azerbaijan on the announcement of the visit of an IMF or World Bank mission. Long awaited legal reform packages were announced, to be passed at any minute. And formal privatisation, which is taken by these supranational organisations as the touchstone for a successful reform process, was proclaimed to be taking place tomorrow. Once the visit was over things cooled down again. However, the immense influence on economic policies by supranational organisations is undeniable:

⁹ Structural reform is mostly concentrated on setting up an adequate legal framework, and financial infrastructure and privatisation. Often privatisation is almost used as a synonym for enterprise restructuring. Macro-economic stabilisation programmes comprise mainly monetary policy (i.e. credit controls), tight fiscal policy (reduction of budget deficits), imposition of strict wage controls, price liberalisation, and exchange rate as nominal anchor (fixed exchange rate, combined with import liberalisation) (cf. Marer/Zecchini 1991).

7.2 Factors influencing the likelihood of agreement on institutional change

Countless factors influence each individual contracting process for institutional change. There will be a lot of country specific factors, as well as factors specific to certain contracting parties. Likewise, the institutional arrangements in different PCPEs vary wildly. In the following only the important common factors are discussed which are also relevant for Azerbaijan (see Table 7-1).

Table 7-1: Factors influencing the likelihood of agreement on institutional change

	<i>Factor</i>
1.	Uncertainty
2.	Imperfect and asymmetric information
3.	The heterogeneity of the contracting parties
4.	The relative bargaining power of each contracting party
5.	Time and precedent

(1) Uncertainty

Due to the volatile political and economic environment in Azerbaijan there is deep uncertainty about future development. Uncertainty can in that sense be understood also as a function of the degree of institutional development, i.e. mainly the relation of informal rights arrangements to formal ones and in how far the political system, the legal framework including its enforcement mechanisms, and the financial infrastructure have developed.¹⁰ As detailed above, informal rights arrangements dominate the institutional setting in Azerbaijan. The prevailing uncertainty has a paralysing effect on all contracting parties and increasingly underpins the status quo. It led to widespread short-term thinking which is not very conducive to institutional change.

(2) Imperfect and asymmetric information

It cannot be expected that the contracting parties have the entire information necessary to calculate their net gains from institutional change at their disposal. Accordingly, they will be not aware of all institutional options. For instance,

¹⁰ See chapter 4 for an assessment of the institutional framework in Azerbaijan.

often the only alternative to the restructuring of an enterprise is its liquidation. This might not always be clear to all parties involved. Insiders will have an information advantage concerning their enterprises relative to other contracting parties. Likewise, bureaucrats will have an information advantage on public policy measures, e.g. on enterprise subsidies etc. Due to information problems of some contracting parties, outright deception can be used to underpin one's position, e.g. the value of assets can be underestimated, benefits can be granted which are never intended to be paid out etc. (cf. Libecap 1993: 24). The high degree of outright deception on all political levels resulted in far-reaching distrust of the entire population, which is a major obstacle to institutional change. The degree of availability of information and the degree of asymmetry of information are an important factor influencing the outcome of contracting.

(3) The heterogeneity of the contracting parties

The heterogeneity of the contracting parties was already discussed above. It depends mainly on differences in wealth and status of its members, differences in the level of information, and political experience (cf. Libecap 1993: 22-23). There is a great heterogeneity within and between contracting parties in Azerbaijan. For example, a manager in the oil industry has more reserves than one in light industry; Aliiev who has been previously KGB chief in Azerbaijan and then Party Secretary for fourteen years knows intimately the strengths and weaknesses of every other politician. The greater the heterogeneity of contracting parties the more difficult it will be to come to an agreement on institutional change, and the more likely it will be that the contracting process will be stalled.

(4) The relative bargaining power of each contracting party

The bargaining power of each contracting party depends on its resources and its contacts and networks.¹¹ The better the bargaining power, the more weight the

¹¹ The emphasis should be here on the resources. However, it is important to note that building up the necessary alliances and coalitions of which contracting consists will take time. Thus, in the short-term, parties with the best contacts and networks will have an advantage.

interests of contracting parties will bear. However, in the long term the positions in bargaining power are quite fragile, due to the volatile environment.

(5) *Time and precedent*

Libecap (1993: 6-7) points out that time and precedent have important roles in contracting:

Precedents set expectations among the various parties for successful institutional change [i.e. changes in governance structures that promote economic growth]. If the political and economic systems are reasonably open to new entrants and there is a history of routine adjustments in property rights, then institutional change to meet specific economic problems is more likely... On the other hand, in less open societies where the status quo has been maintained by influential parties, new external market conditions will not bring the same expectations for institutional change. Depending on the size of the market pressures, the lack of expectations for change will limit the expected returns from forming interest groups within established political structures to lobby for new property rights structures.

In Azerbaijan, as in many other PCPEs, the expectations for institutional change were swiftly disillusioned and proposals of progressive groups were heavily constrained or defeated by vested interests. There are rather negative precedents of institutional change, e.g. corruption and asset stripping, which are not very conducive to positive momentum. However, the development of a suitable legal framework and a record of positive precedence, e.g. the successful restructuring and changes in corporate governance structure of enterprises, is very important for the contracting process. Successful institutional change is, therefore, also dependent on whether a PCPE has already a record of such progress. As chapter 4 showed, Azerbaijan's track record in positive institutional change is very limited.

7.3 Contracting for property rights in Azerbaijan

As discussed before, the institution background of privatisation is very unfavourable. With the decay of the administrative structure the informalisation of economic and social relations has increased dramatically. For example, whilst formally the enterprises are under the control of the state, de facto insider control

is prevalent; officially a bureaucrat or politician receives his/her wage, *de facto* the official wage is only a crumb in relation to his/her informal earnings. Informal arrangements and power struggles also exist in more stable economies but they are far more concealed. As in other PCPEs the gap between officially proclaimed objectives of policies and actions and *de facto* objectives of the key players has widened so far that these discrepancies become too obvious. Attitudes and perceptions of key players and the broader population have adapted accordingly. This is reflected in the far-reaching distrust of officially declared intentions. For example, some interviewees as well as ordinary taxi drivers on the street asked on their opinion on the ASPC suspected the latter to be primarily interested in informal income generation by abusing their discretionary powers; although the officially declared policy line is privatisation, 13% of the respondents and also quite a few interviewees made the lack of interest in privatisation of the ruling elite responsible for the stalling of the privatisation process. The assessment of the contracting process in Azerbaijan has primarily to concentrate on the *de facto* objectives of the key players.

Considering this power constellation in Azerbaijan, it is hardly to be expected that insiders and industrial bureaucracy will easily agree to a property rights constellation which would weaken their position. Parts of the industrial bureaucracy might be interested in legalising their informal ownership rights on their enterprises. However, due to the given uncertainty and imperfect and asymmetric information on both the viability of their enterprises and future industrial and public policy measures, their calculable gain is limited. Most enterprises are in need of fundamental restructuring involving major investments. Serious restructuring in terms of downsizing and streamlining would also erode their very power base, e.g. there is a significant difference between an enterprise of five thousand workers and one with five hundred. Moreover, once the more or less comfortable institutional arrangements with all the other contracting parties are disturbed in a formal privatisation process, parts of the insiders might demand a bigger share in residual income and the *nouveau riche* might try to get a stake in the industry. Short-term strategies of asset stripping and rent-seeking are thus more feasible for the majority of the industrial bureaucracy. This

position is also taken by insiders. Some of the latter might be interested in freeing themselves from their interfering superstructure, i.e. the industrial bureaucracy, in the form of insider privatisation. However, due to the institutional deficiencies in Azerbaijan, it would be hard for them to operate without their protective, well-connected industrial bureaucracy as an ally. The draft privatisation programme would have little effect on the majority of the industrial bureaucracy, other than the almost non-existent wood processing industry and small enterprises in light industry, most of which are in the provinces. Nonetheless, the beginning of the official privatisation process would set precedents and would strengthen new and old bureaucracies interfering with industry. Even if very vaguely dealt with, the programme envisages the unbundling of the conglomerations, although at the same time it suggests the establishment of holding companies and the maintenance of the vertically integrated industrial structures. However, all these propositions are too vague to build on. As for insiders, the programme does not explicitly mention any advantages for them, only for the labour collectives. The latter are too weak and unorganised and most eminently lack the necessary funds to benefit from the programme.

Which position over privatisation do other contracting parties take then? First, the nouveau riche are potential competitors for control rights in industry. However, again, profound uncertainty and asymmetric and imperfect information on the viability of enterprises decreases their incentives. The nouveau riche could have a major interest in the small scale privatisation of the draft privatisation programme, which should be rather termed sale of commercial properties. Small scale privatisation of shops and little service entities has already been carried out either through lease arrangements or sales by the local authorities and other authorities, often through informal arrangements. It is questionable, whether the nouveau riche would have a great advantage in acquiring such properties within a formal privatisation campaign.

Second, politicians, as stated above, are very much interested in maintaining the status quo and even those with true reform intentions are doomed to fail due to the weak judiciary and executive powers and the overall

constellation of power. Moreover, most politicians would resist any restructuring of property rights which would give the industrial bureaucracy or any other contracting party significantly more power. As discussed above, it is highly unlikely that the huge industrial conglomerates will be unbundled. However, if the control of these industries would fall entirely in the hands of the industrial bureaucracy the latter would be a challenge to the political sphere.

Third, the majority of bureaucrats like politicians are very much interested in maintaining the status quo. Major changes in the present property rights would disturb their parasitic relationships to the other contracting parties. Moreover, in the long term, it could also initiate a major restructuring of the public administration. As mentioned above, the 1994 draft privatisation programme would increase the power and thus the informal earning potential of the ASPC significantly. The latter can be understood as the major 'winner' of the privatisation process within the bureaucracy. The small scale privatisation would reduce the power of the local authorities over shopkeepers and small services. It can be assumed that the privatisation programme was held purposely vague regarding the demarcation of responsibilities between different authorities in order to gain support amongst the various parts of the bureaucracy, as the involved authorities can be certain of short-term informal earnings.

Fourth, as stated above, a major driving force behind privatisation is foreign organisations which regard formal privatisation as a significant measure of institutional development. The funds provided by these organisations give some politicians and bureaucrats an incentive to engage in the promotion of the privatisation process, even if only by giving lip service.

Concluding remarks

The evaluation of the contracting process in Azerbaijan shows that the outcome of proposed institutional change will have little resemblance with the initial concept. Even policy programmes initiated with the purest intentions have to consider (a) the alterations due to the contracting process, and (b) its interaction with the de facto system. Thus the final programme can only be a compromise between different contracting parties, and the implementation is going to be

influenced by informal determinants. Moreover, due to latent political instability and the weakness of the state, the very powerful interest groups, which privatisation should seek to defeat, are those on whom the state relies for survival. And the privatisation process has to be carried out mostly by self-seeking bureaucrats whose only interest are their own rent extraction.

Accordingly, institutional reforms are still in the initial stages. However, one glimpse of hope is given by continuously changing power constellations resulting from changing bargaining positions. With most of the productive capacity not running and the increasing decay of the state apparatus it is only a matter of time before the power base of large parts of the industrial bureaucracy will be eroded.

CONCLUSION

The conclusion of the research can be summarised in seven points. First, the analysis of enterprise efficiency in PCPEs has come to the conclusion that the question of formal ownership is rarely central. However, under the circumstances of deeply entrenched rent-seeking, privatisation can be a tool either to involve insiders constructively in the establishment of sound corporate governance structures or, ideally, to effectively exclude them completely.

Second, the success of privatisation in PCPE's depends on various factors, most eminently, (1) the evolution of institutional preconditions, i.e. the development of the political, legal, and financial frameworks and other fundamental institutions of a market environment; (2) the question of the power of the state, i.e. is it a strong state, with agenda-setting power, or a weak state, susceptible to the counter-productive rent-seeking activities of insiders; (3) the proposed methods of privatisation; (4) the process of contracting for property rights. Whilst these conclusions might have been anticipated by those conversant with various recent developments in the economic theory of institutions, they are given more specific analytical and empirical content during the course of this thesis and as elaborated in brief in the following conclusions.

Third, a factor frequently underestimated by the advocates of privatisation in PCPEs, is that the very same powerful interest groups, which privatisation should seek to defeat, are those on whom the state relies for survival. Insider control exists to a different degree in all PCPEs, but its importance is often enhanced by the state's weakness and political instability. Moreover, the bureaucrats involved in the privatisation process are frequently self-seeking, so that their primary interest is in their personal rent extraction.

Fourth, the chosen method of privatisation is a key factor. Chapter 3 has drawn up a transaction cost framework in which methods can be assessed. The free transfer of enterprises to employees approach, followed by ESOP/MBO, competitive tendering and leasing arrangements, promises most success in the given framework. Voucher privatisation schemes have been evaluated as negative for static and dynamic efficiency. However, it has to be noted that the suitability

of the method of privatisation also depends on the kind of enterprise. As mentioned before, factors like size, factor specificity and other enterprise and sector specific factors play a great role.

Fifth, the point of departure in Azerbaijan delineated in this thesis is very bleak. To summarise: first, the Azeri economy has suffered cumulative decline in real GDP of 60% in 1990-1994, with most of its industries either not working or operating at a fraction of their capacity. Second, the industrial sector is characterised by monopolies and generally high concentration, insider control, excess capacity, low profitability, environmental pollution, increasing technological obsolescence, and a largely obsolescent capital stock due to lack of investments and maintenance and also far-reaching asset stripping. As the power constellations have not allowed a thorough inventory of the enterprises as envisaged for years, nobody knows even to what extent the production facilities are still recoverable. Third, the bureaucratic structures are overcrowded and, to a great extent, obsolete. The steady decay of these structures, together with a legal framework which is barely developed to deal with the new requirements, has led to a perverse degree of 'informalisation' of all economic and social relations; to the extent that large sections of the bureaucracy are in practice engaged in informal income generation. Fourth, political parties and organisations are unrepresentative and lack a mass popular base. And, finally, the state is weak and dependent on patronage networks for survival. The tasks faced by political and economic reforms are more pervasive than experienced in most industrialised countries after World War II. It is only to the remarkable capacity of the Azeris to adapt and survive that widespread famine and political turmoil have not broken out.

Taken together, these empirical and historical features are unique to Azerbaijan, just as other countries exhibit specific characteristics of their own. Much of the theoretical and policy literature, in this light, has been shown to be sorely inadequate. This is not simply because it neglects these specific and contingent factors but because it effectively precludes them. This is a major conclusion of the thesis that has been demonstrated in theoretical and empirical detail. By the same token, it provides an invaluable salutary lesson for future

research and for would-be policy makers, especially those armed with the notion of privatisation (and the market) as a panacea for PCPEs - an ideological posture that has demonstratively proved disastrous in practice.

Sixth, it is therefore hardly surprising that the decision to carry out formal privatisation and hence change property rights institutions - the key to the distribution of wealth and political power - has immediately stalled within a complex contracting process. Although, and maybe also because, the draft privatisation programme was such a compromise, it has hardly touched the position of the industrial bureaucracy and most insiders, and it has not gained major support by any key player. The question was posed whether the envisaged privatisation programme is a viable way to enhance enterprise efficiency under the given economic and institutional circumstances. After all, the privatisation process has, to a large extent, crowded out any other form of industrial recovery programmes. There are hardly any steps taken towards industrial restructuring except in the petroleum industry, and there only because of major foreign involvement.

Ultimately, it has to be concluded that rather than engaging in ambitious and fruitless mass privatisation programmes, it is advisable for Azeri policy makers to concentrate on the tasks of industrial restructuring on a sectoral and enterprise level using other industrial policy instruments concerning large enterprises. Privatisation can be used here on a case-to-case basis. Most of the 'small scale' privatisation resembles more the sale of commercial properties and should be dealt with separately. Whether, however, internal and external influences are liable to abandon the panacea of privatisation for more constructive and realistic policies for institutional reform and industrial restructuring is another matter over which there can be little optimism.

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2. In Azerbaijani

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3. Laws and Decrees

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Law 'On Excise Tax in the Republic of Azerbaijan' (adopted in December 1992).

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Law 'On the Customs committee in the Republic of Azerbaijan' (adopted in June 1992).

Law 'On the Joint-Stock Company' (adopted on 12 July 1994).

Law 'On the National Bank in the Republic of Azerbaijan' (adopted in August 1992).

Law 'On the Protection of Foreign Investment in the Republic of Azerbaijan' (adopted in January 1992).

Law 'On Value Added Tax in the Republic of Azerbaijan' (adopted in January 1992).

4. News agency material

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